SUBCHAPTER S REVISION ACT OF 1982

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 2350

SEPTEMBER 10, 1982

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SUBCHAPTER S REVISION ACT OF 1982

FRIDAY, SEPTEMBER 10, 1982

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2221, Dirksen Senate Office Building, Hon. Bob Dole (chairman of the committee) presiding.

Present: Senators Dole, Danforth, Armstrong, Symms, Grassley, Long, and Baucus.

[The committee press release, the bill, S. 2350, the description of the bill by the Joint Committee on Taxation, and the prepared statement of Senator Dole follow:]

[Press Release]

FINANCE COMMITTEE ANNOUNCES HEARING ON SUBCHAPTER S REVISION ACT AND REQUESTS COMMENTS ON TECHNICAL CORRECTIONS FOR 1980 AND 1981 TAX LEGISLATION

Chairman Robert Dole announced today that the Finance Committee will hold a hearing on Friday, September 10, 1982, on S. 2350, the Subchapter S Revision Act of 1982.

The hearing will begin at 10 a.m. in Room 2221 of the Dirksen Senate Office Building.

SUBCHAPTER S

"Last April when Senator Long and I introduced S. 2350, I noted that this legislation represents a major step forward in our ongoing effort to simplify and rationalize the tax code. Chairman Rostenkowski and Representative Conable of the House Ways and Means Committee introduced identical legislation and hearings and markup have already been held in the House. I hope that our hearing will help clear the way for enactment this year," Dole said.

"In general, this bill seeks to remove tax considerations from the choice of form for a small business. By taxing an electing subchapter S corporation more like a partnership, the bill will allow taxpayers to choose to conduct their business in corporate or noncorporate form based solely upon business reasons.

"In general, the bill should be relatively noncontroversial. The Committee, however, will have to resolve two technical issues relating to the potential application of the section 385 'debt-equity' regulations to Subchapter S corporations and the potential for accumulated earnings and profits of a corporation to escape taxation when a corporation terminates its active business and makes a Subchapter S election," Dole indicated. "We would like interested parties to address these issues specifically in comments submitted to the Committee."

97TH CONGRESS
2D SESSION

S. 2350

To revise subchapter S of the Internal Revenue Code of 1954 (relating to small business corporations).

IN THE SENATE OF THE UNITED STATES

APRIL 1 (legislative day, FEBRUARY 22), 1982

Mr. DOLE (for himself and Mr. LONG) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To revise subchapter S of the Internal Revenue Code of 1954 (relating to small business corporations).

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE.

(a) SHORT TITLE.—This Act may be cited as the "Subchapter S Revision Act of 1982".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. AMENDMENT OF SUBCHAPTER S.

Subchapter S of chapter 1 is amended to read as follows:

"Subchapter S—Tax Treatment of S Corporations and Their Shareholders

"Part I. In general.
"Part II. Tax treatment of shareholders.
"Part III. Special rules.
"Part IV. Definitions; miscellaneous.

"PART I—IN GENERAL

"Sec. 1361. S corporation defined.
"Sec. 1362. Election; revocation; termination.
"Sec. 1363. Effect of election on corporation.

"SEC. 1361. S CORPORATION DEFINED.

"(a) S CORPORATION DEFINED.—

"(1) IN GENERAL.—For purposes of this title, the term 'S corporation' means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

"(2) C CORPORATION.—For purposes of this title, the term 'C corporation' means, with respect to any taxable year, a corporation which is not an S corporation for such year.

"(b) SMALL BUSINESS CORPORATION.—

"(1) IN GENERAL.—For purposes of this subchapter, the term 'small business corporation' means a domestic corporation which is not an ineligible corporation and which does not—

"(A) have more than 35 shareholders,

"(B) have as a shareholder a person (other than an estate and other than a trust described in subsection (c)(2)) who is not an individual,

"(C) have a nonresident alien as a shareholder, and

"(D) have more than 1 class of stock.

"(2) INELIGIBLE CORPORATION DEFINED.—For purposes of paragraph (1), the term 'ineligible corporation' means any corporation which is—

"(A) a member of an affiliated group (determined under section 1504 without regard to the exceptions contained in subsection (b) thereof),

"(B) a financial institution to which section 585 or 593 applies,

"(C) an insurance company subject to tax under subchapter L,

"(D) a corporation to which an election under section 936 applies, or

"(E) a DISC or former DISC.

"(c) SPECIAL RULES FOR APPLYING SUBSECTION (b).—

"(1) HUSBAND AND WIFE TREATED AS 1 SHAREHOLDER.—For purposes of subsection (b)(1)(A), a husband and wife (and their estates) shall be treated as 1 shareholder.

"(2) CERTAIN TRUSTS PERMITTED AS SHAREHOLDERS.—

"(A) IN GENERAL.—For purposes of subsection (b)(1)(B), the following trusts may be shareholders:

"(i) A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States.

"(ii) A trust which was described in clause (i) immediately before the death of the deemed owner and which continues in existence after such death, but only for the 60-day period beginning on the day of the deemed owner's death. If a trust is described in the preceding sentence and if the entire corpus of the trust is includible in the gross estate of the deemed owner, the preceding sentence shall be applied by substituting ‘2-year period’ for ‘60-day period’.

“(iii) A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 60-day period beginning on the day on which such stock is transferred to it.

“(iv) A trust created primarily to exercise the voting power of stock transferred to it.

This subparagraph shall not apply to any foreign trust.

“(B) TREATMENT AS SHAREHOLDERS.—For purposes of subsection (b)(1)(A)—

“(i) In the case of a trust described in clause (i) of subparagraph (A), the deemed owner shall be treated as the shareholder.

“(ii) In the case of a trust described in clause (ii) of subparagraph (A), the estate of the deemed owner shall be treated as the shareholder.

“(iii) In the case of a trust described in clause (iii) of subparagraph (A), the estate of the testator shall be treated as the shareholder.

"(iv) In the case of a trust described in clause (iv) of subparagraph (A), each beneficiary of the trust shall be treated as a shareholder.

"(3) ESTATE OF INDIVIDUAL IN BANKRUPTCY MAY BE SHAREHOLDER.—For purposes of subsection (b)(1)(B), the term 'estate' includes the estate of an individual in a case under title 11 of the United States Code.

"(4) DIFFERENCES IN COMMON STOCK VOTING RIGHTS DISREGARDED.—For purposes of subsection (b)(1)(D), a corporation shall not be treated as having more than 1 class of stock solely because there are differences in voting rights among the shares of common stock.

"(5) OWNERSHIP OF STOCK IN CERTAIN INACTIVE CORPORATIONS.—For purposes of subsection (b)(2)(A), a corporation shall not be treated as a member of an affiliated group at any time during any taxable year by reason of the ownership of stock in another corporation if such other corporation—

"(A) has not begun business at any time on or after the date of its incorporation and before the close of such taxable year, and

"(B) does not have taxable income for the period included within such taxable year.

"(d) SPECIAL RULE FOR QUALIFIED SUBCHAPTER S TRUST.—

"(1) IN GENERAL.—In the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under paragraph (2)—

"(A) such trust shall be treated as a trust described in subsection (c)(2)(A)(i), and

"(B) for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made.

"(2) ELECTION.—

"(A) IN GENERAL.—A beneficiary of a qualified subchapter S trust (or his legal representative) may elect to have this subsection apply.

"(B) MANNER AND TIME OF ELECTION.—An election under this paragraph shall be made—

"(i) separately with respect to each S corporation the stock of which is held by the trust, "(ii) separately with respect to each successive income beneficiary of the trust, and

"(iii) in such manner and form, and at such time, as the Secretary may prescribe.

"(C) Election irrevocable.—An election under this paragraph, once made, may be revoked only with the consent of the Secretary.

"(D) Grace period.—An election under this paragraph shall be effective up to 60 days before the date of the election.

"(3) Qualified subchapter S trust.—For purposes of this subsection, the term 'qualified subchapter S trust' means a trust—

"(A) which owns stock in 1 or more S corporations,

"(B) all of the income (within the meaning of section 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen, or

"(C) the terms of which require that—

"(i) at any time, there shall be only 1 income beneficiary of the trust, "(ii) any corpus distributed during the term of the trust may be distributed only to the current income beneficiary thereof,

"(iii) each income interest in the trust shall terminate on the earlier of the death of the income beneficiary or the termination of the trust, and

"(iv) upon the termination of the trust during the life of an income beneficiary, the trust shall distribute all of its assets to such income beneficiary.

"(4) TRUST CEASING TO BE QUALIFIED.—If a qualified subchapter S trust ceases to meet any requirement under paragraph (3), the provisions of this subsection shall not apply to such trust as of the date it ceases to meet such requirements.

"SEC. 1362. ELECTION; REVOCATION; TERMINATION.

"(a) ELECTION.—

"(1) IN GENERAL.—Except as provided in subsection (g), a small business corporation may elect, in accordance with the provisions of this section, to be an S corporation.

"(2) ALL SHAREHOLDERS MUST CONSENT TO ELECTION.—An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.

“(b) WHEN MADE.—

“(1) IN GENERAL.—An election under subsection (a) may be made by a small business corporation for any taxable year—

“(A) at any time during the preceding taxable year, or

“(B) at any time during the taxable year and on or before the 15th day of the 3d month of the taxable year.

“(2) CERTAIN ELECTIONS MADE DURING 1ST 2½ MONTHS TREATED AS MADE FOR NEXT TAXABLE YEAR.—If—

“(A) an election under subsection (a) is made for any taxable year during such year and on or before the 15th day of the 3d month of such year, but

“(B) either—

“(i) on 1 or more days in such taxable year before the day on which the election was made the corporation did not meet the requirements of subsection (b) of section 1361, or "(ii) 1 or more of the persons who held stock in the corporation during such taxable year and before the election was made did not consent to the election,

then such election shall be treated as made for the following taxable year.

"(3) ELECTION MADE AFTER 1ST 2½ MONTHS TREATED AS MADE FOR FOLLOWING TAXABLE YEAR.—If—

"(A) a small business corporation makes an election under subsection (a) for any taxable year, and

"(B) such election is made after the 15th day of the 3d month of the taxable year and on or before the last day of such taxable year,

then such election shall be treated as made for the following taxable year.

"(c) YEARS FOR WHICH EFFECTIVE.—An election under subsection (a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until such election is terminated under subsection (d).

"(d) TERMINATION.—

"(1) BY REVOCATION.—

"(A) IN GENERAL.—An election under subsection (a) may be terminated by revocation.

"(B) ONE-HALF OF SHAREHOLDERS MUST CONSENT TO REVOCATION.—An election may be revoked only if shareholders holding more than one-half of the shares of stock of the corporation on the day on which the revocation is made consent to the revocation.

"(C) WHEN EFFECTIVE.—Except as provided in subparagraph (D)—

"(i) a revocation made during the taxable year and on or before the 15th day of the 3d month thereof shall be effective on the 1st day of such taxable year, and

"(ii) a revocation made during the taxable year but after such 15th day shall be effective on the 1st day of the following taxable year.

"(D) REVOCATION MAY SPECIFY PROSPECTIVE DATE.—If the revocation specifies a date for revocation which is on or after the day on which the revocation is made, the revocation shall be effective on and after the date so specified.

"(2) BY CORPORATION CEASING TO BE SMALL BUSINESS CORPORATION.—

"(A) IN GENERAL.—An election under subsection (a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

"(B) WHEN EFFECTIVE.—Any termination under this paragraph shall be effective on and after the date of cessation.

"(3) WHERE PASSIVE INVESTMENT INCOME EXCEEDS 20 PERCENT OF GROSS RECEIPTS AND CORPORATION HAS ACCUMULATED EARNINGS AND PROFITS.—

"(A) TERMINATION.—

"(i) IN GENERAL.—An election under subsection (a) shall be terminated whenever the corporation—

"(I) has gross receipts for any taxable year more than 20 percent of which is passive investment income, and

"(II) has accumulated earnings and profits at the close of such taxable year.

"(ii) WHEN EFFECTIVE.—Any termination under this paragraph shall be effective on and after the first day of the taxable year referred to in clause (i).

"(B) Exception.—Subparagraph (A) shall not apply with respect to a taxable year if—

"(i) such taxable year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year, and

"(ii) the amount of passive investment income for such taxable year is less than $3,000.

"(C) Passive investment income defined.—For purposes of this paragraph, the term 'passive investment income' means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Gross receipts derived from sales or exchanges of stock or securities for purposes of this paragraph shall not include amounts received by an S corporation which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock where the S corporation owned more than 50 percent of each class of the stock of the liquidating corporation.

"(4) FOREIGN INCOME.—

"(A) TERMINATION.—An election under subsection (a) shall be terminated whenever the corporation derives more than 80 percent of its gross receipts for any taxable year from sources without the United States.

"(B) WHEN EFFECTIVE.—Any termination under this paragraph shall be effective on and after the first day of the taxable year referred to in subparagraph (A).

"(e) TREATMENT OF S TERMINATION YEAR.—

"(1) IN GENERAL.—In the case of an S termination year, for purposes of this title—

"(A) S SHORT YEAR.—The portion of such year ending before the 1st day for which the termination is effective shall be treated as a short taxable year for which the corporation is an S corporation.

"(B) C SHORT YEAR.—The portion of such year beginning on such 1st day shall be treated as a short taxable year for which the corporation is a C corporation.

"(2) Pro rata allocation.—Except as provided in paragraph (3), the determination of which items are to be taken into account for each of the short taxable years referred to in paragraph (1) shall be made—

"(A) first by determining for the S termination year—

"(i) the amount of each of the items of income, loss, deduction, or credit described in section 1366(a)(1)(A), and

"(ii) the amount of the nonseparately computed income or loss, and

"(B) then by assigning an equal portion of each amount determined under subparagraph (A) to each day of the S termination year.

"(3) Election to have items assigned to each short taxable year under normal tax accounting rules.—

"(A) In general.—A corporation may elect to have paragraph (2) not apply.

"(B) All shareholders must consent to election.—An election under this paragraph shall be valid only if all persons who are shareholders in the corporation at any time during the S termination year consent to such election.

"(4) S termination year.—For purposes of this subsection, the term 'S termination year' means any taxable year of a corporation in which a termination of an election made under subsection (a) takes effect (other than on the 1st day thereof).

"(5) Tax for C short year determined on annualized basis.—

"(A) In general.—The taxable income for the short year described in subparagraph (B) of paragraph (1) shall be placed on an annual basis by multiplying the taxable income for such short year by the number of days in the S termination year and by dividing the result by the number of days in the short year. The tax shall be the same part of the tax computed on the annual basis as the number of days in such short year is of the number of days in the S termination year.

"(B) Section 443(d)(2) to apply.—Subsection (d)(2) of section 443 shall apply to the short taxable year described in subparagraph (B) of paragraph (1).

"(6) Other special rules.—For purposes of this title—

"(A) Short years treated as 1 year for carryover purposes.—The short taxable year described in subparagraph (A) of paragraph (1) shall not be taken into account for purposes of determining the number of taxable years to which any item may be carried back or carried forward by the corporation.

"(B) Due date for S year.—The due date for filing the return for the short taxable year described in subparagraph (A) of paragraph (1) shall be the same as the due date for filing the return for the short taxable year described in subparagraph (B) of paragraph (1) (including extensions thereof).

"(f) Inadvertent Terminations.—If—

"(1) an election under subsection (a) by any corporation was terminated under paragraph (2), (3), or (4) of subsection (d),

"(2) the Secretary determines that the termination was inadvertent,

"(3) no later than a reasonable period of time after discovery of the event resulting in such termination, steps were taken so that the corporation is once more a small business corporation, and

"(4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period,

then, notwithstanding the terminating event, such corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

"(g) ELECTION AFTER TERMINATION.—If a small business corporation has made an election under subsection (a) and if such election has been terminated under subsection (d), such corporation (and any successor corporation) shall not be eligible to make an election under subsection (a) for any taxable year before its 5th taxable year which begins after the 1st taxable year for which such termination is effective, unless the Secretary consents to such election.

"SEC. 1363. EFFECT OF ELECTION ON CORPORATION.

"(a) GENERAL RULE.—Except as otherwise provided in this subchapter and in section 58(d), an S corporation shall not be subject to the taxes imposed by this chapter.

"(b) COMPUTATION OF CORPORATION'S TAXABLE INCOME.—The taxable income of an S corporation shall be computed in the same manner as in the case of an individual, except that—

"(1) the items described in section 1366(a)(1)(A) shall be separately stated, "(2) the deductions referred to in section 703(a)(2) shall not be allowed to the corporation, and

"(3) section 248 shall apply.

"(c) ELECTIONS OF THE S CORPORATION.—

"(1) IN GENERAL.—Except as provided in paragraph (2), any election affecting the computation of items derived from an S corporation shall be made by the corporation.

"(2) EXCEPTIONS.—In the case of an S corporation, elections under the following provisions shall be made by each shareholder separately—

"(A) subsection (b)(5) or (d)(4) of section 108 (relating to income from discharge of indebtedness),

"(B) section 163(d) (relating to limitation on interest on investment indebtedness),

"(C) section 617 (relating to deduction and recapture of certain mining exploration expenditures), and

"(D) section 901 (relating to taxes of foreign countries and possessions of the United States).

"(d) DISTRIBUTIONS OF APPRECIATED PROPERTY.—

"(1) IN GENERAL.—If—

"(A) an S corporation makes a distribution of property (other than an obligation of such corporation) with respect to its stock, and

"(B) the fair market value of such property exceeds its adjusted basis in the hands of the S corporation,

then gain shall be recognized to the S corporation on the distribution in the same manner as if it had sold such property to the distributee at its fair market value.

"(2) COORDINATION WITH SECTION 311.—Proper adjustment shall be made in the gain recognized under paragraph (1) for any gain recognized under section 311.

"(3) PARTIAL LIQUIDATIONS TREATED LIKE DISTRIBUTIONS.—For purposes of this subsection and sections 311 and 336, a distribution of property in partial liquidation of an S corporation (other than a distribution described in paragraph (1) of section 346(a)) shall be treated as a distribution with respect to the stock of such corporation.

"PART II—TAX TREATMENT OF SHAREHOLDERS

"Sec. 1366. Pass-thru of items to shareholders.
"Sec. 1367. Adjustments to basis of stock of shareholders, etc.
"Sec. 1368. Distributions.

"SEC. 1366. PASS-THRU OF ITEMS TO SHAREHOLDERS.

"(a) DETERMINATION OF SHAREHOLDER'S TAX LIABILITY.—

"(1) IN GENERAL.—In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends, there shall be taken into account the shareholder's pro rata share of the corporation's—

"(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

"(B) nonseparately computed income or loss.

"(2) NONSEPARATELY COMPUTED INCOME OR LOSS DEFINED.—For purposes of this subchapter, the term 'nonseparately computed income or loss' means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).

"(b) CHARACTER PASSED THRU.—The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

"(c) GROSS INCOME OF A SHAREHOLDER.—In any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation.

"(d) SPECIAL RULES FOR LOSSES AND DEDUCTIONS.—

"(1) CANNOT EXCEED SHAREHOLDER'S BASIS IN STOCK AND DEBT.—The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of—

"(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraph (1) of section 1367(a) for the taxable year), and

"(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

"(2) INDEFINITE CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS.—Any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

"(3) CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS TO POST-TERMINATION TRANSITION PERIOD.—

"(A) IN GENERAL.—If for the last taxable year of a corporation for which it was an S corporation a loss or deduction was disallowed by reason of paragraph (1), such loss or deduction shall be treated as incurred by the shareholder on the last day of any post-termination transition period.

"(B) CANNOT EXCEED SHAREHOLDER'S BASIS IN STOCK.—The aggregate amount of losses and deductions taken into account by a shareholder under subparagraph (A) shall not exceed the adjusted basis of the shareholder's stock in the corporation (determined at the close of the last day of the post-termination transition period and without regard to this paragraph).

"(C) ADJUSTMENT IN BASIS OF STOCK.—The shareholder's basis in the stock of the corporation shall be reduced by the amount allowed as a deduction by reason of this paragraph.

"(e) TREATMENT OF FAMILY GROUP.—If an individual who is a member of the family (within the meaning of section 704(e)(3)) of one or more shareholders of an S corporation renders services for the corporation or furnishes capital to the corporation without receiving reasonable compensation therefor, the Secretary shall make such adjustments in the items taken into account by such individual and such shareholders as may be necessary in order to reflect the value of such services or capital.

"(f) SPECIAL RULES.—

"(1) SECTION NOT TO APPLY TO CREDIT ALLOWABLE UNDER SECTION 39.—Subsection (a) shall not apply with respect to any credit allowable under section 39 (relating to certain uses of gasoline, special fuels, and lubricating oil).

"(2) REDUCTION IN PASS-THRU FOR TAX IMPOSED ON CAPITAL GAIN.—If any tax is imposed under section 56 or 1374 for any taxable year on an S corporation, for purposes of subsection (a)—

"(A) the amount of the corporation's long-term capital gains for the taxable year shall be reduced by the amount of such tax, and

"(B) if the amount of such tax exceeds the amount of such long-term capital gains, the corporation's gains from sales or exchanges of property described in section 1231 shall be reduced by the amount of such excess.

For purposes of the preceding sentence, the term 'long-term capital gain' shall not include any gain from the sale or exchange of property described in section 1231.

"SEC. 1367. ADJUSTMENTS TO BASIS OF STOCK OF SHAREHOLDERS, ETC.

"(a) GENERAL RULE.—

"(1) INCREASES IN BASIS.—The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

"(A) the items of income described in subparagraph (A) of section 1366(a)(1),

"(B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and

"(C) the excess of the deductions for depletion over the basis of the property subject to depletion.

"(2) DECREASES IN BASIS.—The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

"(A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,

"(B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),

"(C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),

"(D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and

"(E) the amount of the shareholder's deduction for depletion under section 611 with respect to oil and gas wells.

"(b) Special Rules.—

"(1) Income items.—An amount which is required to be included in the gross income of a shareholder and shown on his return shall be taken into account under subparagraph (A) or (B) of subsection (a)(1) only to the extent such amount is included in the shareholder's gross income on his return, increased or decreased by any adjustment of such amount in a redetermination of the shareholder's tax liability.

"(2) ADJUSTMENTS IN BASIS OF INDEBTEDNESS.—

"(A) REDUCTION OF BASIS.—If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.

"(B) RESTORATION OF BASIS.—If for any taxable year there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

"(3) COORDINATION WITH SECTION 165(g).—This section and section 1366 shall be applied before the application of section 165(g) to any taxable year of the shareholder in which the stock becomes worthless.

"SEC. 1368. DISTRIBUTIONS.

"(a) GENERAL RULE.—A distribution of property made by an S corporation with respect to its stock to which (but for this subsection) section 301(c) would apply shall be treated in the manner provided in subsection (b) or (c), whichever applies.

"(b) S CORPORATION HAVING NO EARNINGS AND PROFITS.—In the case of a distribution described in subsection (a) by an S corporation which has no accumulated earnings and profits—

"(1) AMOUNT APPLIED AGAINST BASIS.—The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock.

"(2) AMOUNT IN EXCESS OF BASIS.—If the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property.

"(c) S CORPORATION HAVING EARNINGS AND PROFITS.—In the case of a distribution described in subsection (a) by an S corporation which has accumulated earnings and profits—

"(1) ACCUMULATED ADJUSTMENTS ACCOUNT.—That portion of the distribution which does not exceed the accumulated adjustments account shall be treated in the manner provided by subsection (b).

"(2) DIVIDEND.—That portion of the distribution which remains after the application of paragraph (1) shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S corporation.

"(3) TREATMENT OF REMAINDER.—Any portion of the distribution remaining after the application of paragraph (2) of this subsection shall be treated in the manner provided by subsection (b).

"(d) CERTAIN ADJUSTMENTS TAKEN INTO ACCOUNT.—Subsections (b) and (c) shall be applied by taking into account (to the extent proper)—

"(1) the adjustments to the basis of the shareholder's stock described in section 1367, and

"(2) the adjustments to the accumulated adjustments account which are required by subsection (e)(1).

"(e) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) ACCUMULATED ADJUSTMENTS ACCOUNT.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'accumulated adjustments account' means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under section 1367 (except that no adjustment shall be made for income which is exempt from tax under this title and no adjustment shall be made for any expense not deductible in computing the corporation's taxable income and not properly chargeable to capital account).

"(B) AMOUNT OF ADJUSTMENT IN THE CASE OF REDEMPTIONS, ETC.—In the case of any partial liquidation or of any redemption which is treated as an exchange under section 302(a) or 303(a), the adjustment in the accumulated adjustments account shall be an amount which bears the same ratio to the balance in such account as the number of shares redeemed in such redemption bears to the number of shares of stock in the corporation immediately before such redemption.

"(2) S PERIOD.—The term 'S period' means the most recent continuous period during which the corporation has been an S corporation. Such period shall not include any taxable year beginning before January 1, 1983.

"PART III—SPECIAL RULES

"Sec. 1371. Coordination with subchapter C.
"Sec. 1372. Coordination with part I of subchapter D, etc.
"Sec. 1373. Foreign income.
"Sec. 1374. Tax imposed on certain capital gains.
"Sec. 1375. Administration.

"SEC. 1371. COORDINATION WITH SUBCHAPTER C.

"(a) APPLICATION OF SUBCHAPTER C RULES.—

"(1) IN GENERAL.—Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders.

"(2) S CORPORATION AS SHAREHOLDER TREATED LIKE INDIVIDUAL.—For purposes of subchapter C, an S corporation in its capacity as a shareholder of another corporation shall be treated as an individual.

"(b) NO CARRYOVER BETWEEN C YEAR AND S YEAR.—

"(1) FROM C YEAR TO S YEAR.—No carryforward, and no carryback, arising for a taxable year for which a corporation is a C corporation may be carried to a taxable year for which such corporation is an S corporation.

"(2) NO CARRYOVER FROM S YEAR.—No carryforward, and no carryback, shall arise at the corporate level for a taxable year for which a corporation is an S corporation.

"(3) TREATMENT OF S YEAR AS ELAPSED YEAR.—Nothing in paragraphs (1) and (2) shall prevent treating a taxable year for which a corporation is an S corporation as a taxable year for purposes of determining the number of taxable years to which an item may be carried back or carried forward.

"(c) EARNINGS AND PROFITS.—

"(1) IN GENERAL.—Except as provided in paragraphs (2) and (3), no adjustment shall be made to the earnings and profits of an S corporation.

"(2) ADJUSTMENTS FOR REDEMPTIONS, LIQUIDATIONS, REORGANIZATIONS, DIVISIVES, ETC.—In the case of any transaction involving the application of subchapter C to any S corporation, proper adjustment to any accumulated earnings and profits of the corporation shall be made.

"(3) ADJUSTMENTS IN CASE OF DISTRIBUTIONS TREATED AS DIVIDENDS UNDER SECTION 1368(c)(2).—Paragraph (1) shall not apply with respect to that portion of a distribution which is treated as a dividend under section 1368(c)(2).

"(d) COORDINATION WITH INVESTMENT CREDIT RECAPTURE.—

"(1) NO RECAPTURE BY REASON OF ELECTION.—Any election under section 1362 shall be treated as a mere change in the form of conducting a trade or business for purposes of the second sentence of section 47(b).

"(2) CORPORATION CONTINUES TO BE LIABLE.—Notwithstanding an election under section 1362, an S corporation shall continue to be liable for any increase in tax under section 47 attributable to credits allowed for taxable years for which such corporation was not an S corporation.

"(e) Cash Distributions During Post-Termination Transition Period.—Any distribution of money by a corporation with respect to its stock during a post-termination transition period shall be applied against and reduce the adjusted basis of the stock, to the extent that the amount of the distribution does not exceed the accumulated adjustments account.

"SEC. 1372. COORDINATION WITH PART I OF SUBCHAPTER D, ETC.

"(a) Partnership Rules To Apply for Deferred Compensation Purposes.—For purposes of part I of subchapter D (and all other provisions of this title which relate to deferred compensation with respect to owner-employees or employees within the meaning of section 401(c)(1))—

"(1) any 2-percent shareholder of an S corporation who is an employee of such corporation—

"(A) shall be treated as an employee within the meaning of section 401(c)(1), and

"(B) if such shareholder is a 10-percent shareholder, shall be treated as an owner-employee within the meaning of section 401(c)(3), and

"(2) compensation received or accrued by such shareholder from the corporation shall be treated as earned income.

"(b) Percentage Shareholders Defined.—

"(1) 2-PERCENT SHAREHOLDER.—For purposes of this section, the term '2-percent shareholder' means any person who owns (or is considered as owning within the meaning of section 318) on any day during the taxable year of the S corporation more than 2 percent of the outstanding stock of such corporation or stock possessing more than 2 percent of the total combined voting power of all stock of such corporation.

"(2) 10-PERCENT SHAREHOLDER.—For purposes of this section, the term '10-percent shareholder' means a person who would be described in paragraph (1) if '10 percent' were substituted for '2 percent' each place it appears therein.

"(c) Partnership Rules To Apply for Fringe Benefit Purposes.—For purposes of applying the provisions of this subtitle which relate to employee fringe benefits—

"(1) the S corporation shall be treated as a partnership, and

"(2) any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership.

"SEC. 1373. FOREIGN INCOME.

"(a) S CORPORATION TREATED AS PARTNERSHIP, ETC.—For purposes of subparts A and F of part III, and part V, of subchapter N (relating to income from sources without the United States)—

"(1) an S corporation shall be treated as a partnership, and

"(2) the shareholders of such corporation shall be treated as partners of such partnership.

"(b) RECAPTURE OF OVERALL FOREIGN LOSS.—For purposes of section 904(f) (relating to recapture of overall foreign loss), the making or termination of an election to be treated as an S corporation shall be treated as a disposition of the business.

"SEC. 1374. TAX IMPOSED ON CERTAIN CAPITAL GAINS.

"(a) GENERAL RULE.—If for a taxable year of an S corporation—

"(1) the net capital gain of such corporation exceeds $25,000, and exceeds 50 percent of its taxable income for such year, and

"(2) the taxable income of such corporation for such year exceeds $25,000,

there is hereby imposed a tax (computed under subsection (b)) on the income of such corporation.

"(b) AMOUNT OF TAX.—The tax imposed by subsection (a) shall be the lower of—

"(1) an amount equal to the tax, determined as provided in section 1201(a), on the amount by which the net capital gain of the corporation for the taxable year exceeds $25,000, or

"(2) an amount equal to the tax which would be imposed by section 11 on the taxable income of the corporation for the taxable year if the corporation were not an S corporation.

No credit shall be allowable under part IV of subchapter A of this chapter (other than under section 39) against the tax imposed by subsection (a).

"(c) EXCEPTIONS.—

"(1) IN GENERAL.—Subsection (a) shall not apply to an S corporation for any taxable year if the election under section 1362(a) which is in effect with respect to such corporation for such taxable year has been in effect for the 3 immediately preceding taxable years.

"(2) NEW CORPORATIONS.—Subsection (a) shall not apply to an S corporation if—

"(A) it (and any predecessor corporation) has been in existence for less than 4 taxable years, and

"(B) an election under section 1362(a) has been in effect with respect to such corporation for each of its taxable years.

"(3) PROPERTY WITH SUBSTITUTED BASIS.—If—

"(A) but for paragraph (1) or (2), subsection (a) would apply for the taxable year,

"(B) any long-term capital gain is attributable to property acquired by the S corporation during the period beginning 3 years before the first day of the taxable year and ending on the last day of the taxable year, and

"(C) the basis of such property is determined in whole or in part by reference to the basis of any property in the hands of another corporation which was not an S corporation throughout all of the period described in subparagraph (B) before the transfer by such other corporation and during which such other corporation was in existence,

then subsection (a) shall apply for the taxable year, but the amount of the tax determined under subsection (b) shall not exceed a tax, determined as provided in section 1201(a), on the net capital gain attributable to property acquired as provided in subparagraph (B) and having a basis described in subparagraph (C).

"(d) DETERMINATION OF TAXABLE INCOME.—For purposes of subsections (a)(2) and (b)(2), taxable income of the corporation shall be determined under section 63(a) without regard to—

"(1) the deduction allowed by section 172 (relating to net operating loss deduction), and

"(2) the deductions allowed by part VII of subchapter B (other than the deduction allowed by section 248, relating to organization expenditures).

"SEC. 1375. ADMINISTRATION.

"(a) TAX TREATMENT DETERMINED AT CORPORATE LEVEL.—Except as otherwise provided in regulations prescribed by the Secretary, the tax treatment of any subchapter S item shall be determined at the corporate level.

"(b) SHAREHOLDER'S RETURN MUST BE CONSISTENT WITH CORPORATE RETURN OR SECRETARY NOTIFIED OF INCONSISTENCY.—A shareholder of an S corporation shall, on such shareholder's return, treat a subchapter S item in a manner which is consistent with the treatment of such item on the corporate return unless the shareholder notifies the Secretary (at the time and in the manner prescribed by regulations) of the inconsistency.

"(c) ALL SHAREHOLDERS TO BE NOTIFIED OF PROCEEDINGS AND GIVEN OPPORTUNITY TO PARTICIPATE.—In the manner and at the time prescribed in regulations, each shareholder in a subchapter S corporation shall be given notice of, and an opportunity to participate in, any administrative or judicial proceeding for the determination at the corporate level of any subchapter S item.

"(d) SECRETARY TO RECOMMEND CHANGES.—Within 120 days after the date of the enactment of this section, the Secretary shall recommend to the Committee on Ways and Means of the House of Representatives and to the Committee on Finance of the Senate—

"(1) such changes in the periods for assessing deficiencies, and for filing claims for credit or refund, with respect to subchapter S items,

"(2) such changes in the procedure for administrative and judicial determination of subchapter S items, and

"(3) such other changes in subtitle F with respect to subchapter S items,

as may be necessary or appropriate for the effective and efficient administration of this title with respect to subchapter S corporations and their shareholders.

"(e) SUBCHAPTER S ITEM DEFINED.—For purposes of this section, the term 'subchapter S item' means any item of income (including tax-exempt income), loss, deduction, or credit of an S corporation.

"PART IV—DEFINITIONS; MISCELLANEOUS

"Sec. 1377. Definitions and special rule.
"Sec. 1378. Taxable year of S corporation.
"Sec. 1379. Transitional rules on enactment.

"SEC. 1377. DEFINITIONS AND SPECIAL RULE.

"(a) PRO RATA SHARE.—For purposes of this subchapter—

"(1) IN GENERAL.—Except as provided in paragraph (2), each shareholder's pro rata share of any item for any taxable year shall be the sum of the amounts determined with respect to the shareholder—

"(A) by assigning an equal portion of such item to each day of the taxable year, and

"(B) then by dividing that portion pro rata among the shares outstanding on such day.

"(2) ELECTION TO TERMINATE YEAR.—Under regulations prescribed by the Secretary, if any shareholder terminates his interest in the corporation during the taxable year and all persons who are shareholders during the taxable year agree to the application of this paragraph, paragraph (1) shall be applied as if the taxable year consisted of 2 taxable years the first of which ends on the date of the termination.

"(b) POST-TERMINATION TRANSITION PERIOD.—

"(1) IN GENERAL.—For purposes of this subchapter, the term 'post-termination transition period' means—

"(A) the period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of—

"(i) the day which is 1 year after such last day, or

"(ii) the due date for filing the return for such last year as an S corporation (including extensions), and

"(B) the 120-day period beginning on the date of a determination that the corporation's election under section 1362(a) had terminated for a previous taxable year.

"(2) Determination defined.—For purposes of paragraph (1), the term 'determination' means—

"(A) a court decision which becomes final,

"(B) a closing agreement, or

"(C) an agreement between the corporation and the Secretary that the corporation failed to qualify as an S corporation.

"(c) Manner of Making Elections, Etc.—Any election under this subchapter, and any revocation under section 1362(d)(1), shall be made in such manner as the Secretary shall by regulations prescribe.

"SEC. 1378. TAXABLE YEAR OF S CORPORATION.

"(a) General Rule.—For purposes of this subtitle—

"(1) an S corporation shall not change its taxable year to any accounting period other than a permitted year, and

"(2) no corporation may make an election under section 1362(a) for any taxable year unless such taxable year is a permitted year.

"(b) PERMITTED YEAR DEFINED.—For purposes of this section, the term 'permitted year' means a taxable year which—

"(1) is a year ending December 31, or

"(2) is any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Secretary.

"(c) EXISTING S CORPORATIONS REQUIRED TO USE PERMITTED YEAR AFTER 50-PERCENT SHIFT IN OWNERSHIP.—

"(1) IN GENERAL.—A corporation which is an S corporation for a taxable year which includes December 31, 1982, shall not be treated as an S corporation for any subsequent taxable year beginning after the first day on which more than 50 percent of the stock is newly owned stock unless such subsequent taxable year is a permitted year.

"(2) NEWLY OWNED STOCK.—For purposes of paragraph (1), the stock held by any person on any day shall be treated as newly owned stock to the extent that—

"(A) the percentage of the stock of such corporation owned by such person on such day, exceeds

"(B) the percentage of the stock of such corporation owned by such person on December 31, 1982.

"(3) STOCK ACQUIRED BY REASON OF DEATH.—For purposes of paragraph (2), if—

"(A) a person acquires stock in the corporation after December 31, 1982, and

"(B) such stock was acquired by reason of the death of a person who held such stock (or predecessor stock) on such date,

then such stock shall be treated as held on December 31, 1982, by the person described in subparagraph (A). A similar rule shall apply in the case of a series of such acquisitions.

"SEC. 1379. TRANSITIONAL RULES ON ENACTMENT.

"(a) OLD ELECTIONS.—Any election made under section 1372(a) (as in effect before the enactment of the Subchapter S Revision Act of 1982) shall be treated as an election made under section 1362.

"(b) REFERENCES TO PRIOR LAW INCLUDED.—In applying this subchapter to any taxable year beginning after December 31, 1982, any reference in this subchapter to another provision of this subchapter shall, to the extent not inconsistent with the purposes of this subchapter, include a reference to the corresponding provision as in effect before the enactment of the Subchapter S Revision Act of 1982.

"(c) DISTRIBUTIONS OF UNDISTRIBUTED TAXABLE INCOME.—

"(1) IN GENERAL.—If a corporation was an electing small business corporation for the last preenactment year and is an S corporation for the 1st postenactment year, subsections (f) and (d) of section 1375 (as in effect before the enactment of the Subchapter S Revision Act of 1982) shall continue to apply for the period ending on the 15th day of the 3d month following the close of the 1st postenactment year.

"(2) EXTENSION OF 2½-MONTH PERIOD.—For purposes of paragraph (1), the period set forth in such subsection (f) shall be treated as the period which includes the 1st postenactment taxable year and the 2½-month period after the close of such year.

"(d) CARRYFORWARDS.—If a corporation was an electing small business corporation for the last preenactment year and is an S corporation for the 1st postenactment year, any carryforward to the 1st postenactment year which arose in a taxable year for which the corporation was an electing small business corporation shall be treated as arising in the 1st postenactment year.

"(e) Preenactment and Postenactment Years Defined.—For purposes of this subsection—

"(1) Last preenactment year.—The term 'last preenactment year' means the last taxable year of a corporation which begins before January 1, 1983.

"(2) 1st postenactment year.—The term '1st postenactment year' means the 1st taxable year of a corporation which begins after December 31, 1982."

SEC. 3. S CORPORATION TREATED LIKE PARTNERSHIP FOR PURPOSES OF CERTAIN PROVISIONS.

(a) Depletion in the Case of Oil and Gas Wells (Section 613A).—Subsection (c) of section 613A (relating to exemption for independent producers and royalty owners) is amended by adding at the end thereof the following new paragraph:

"(13) Subchapter S corporations.—

"(A) Computation of depletion allowance at shareholder level.—In the case of an S corporation, the allowance for depletion with respect to any oil or gas property shall be computed separately by each shareholder.

"(B) Allocation of basis.—The S corporation shall allocate to each shareholder his pro rata share of the adjusted basis of the S corporation in each oil or gas property held by the S corporation. The allocation shall be made as of the later of the date of acquisition of the property by the S corporation, or the first day of the first taxable year of the S corporation to which the Subchapter S Revision Act of 1982 applies. Each shareholder shall separately keep records of his share of the adjusted basis in each oil and gas property of the S corporation, adjust such share of the adjusted basis for any depletion taken on such property, and use such adjusted basis each year in the computation of his cost depletion or in the computation of his gain or loss on the disposition of such property by the S corporation. In the case of any distribution of oil or gas property to its shareholders by the S corporation, the corporation's adjusted basis in the property shall be an amount equal to the sum of the shareholders' adjusted bases in such property, as determined under this subparagraph.

"(C) COORDINATION WITH TRANSFER RULE OF PARAGRAPH (9).—For purposes of paragraph (9)—

"(i) an S corporation shall be treated as a partnership, and the shareholders of the S corporation shall be treated as partners, and

"(ii) an election by a C corporation to become an S corporation shall be treated as a transfer of all its properties effective on the day on which such election first takes effect.

"(D) COORDINATION WITH TRANSFER RULE OF PARAGRAPH (10).—For purposes of paragraphs (9) and (10), if an S corporation becomes a C corporation, each shareholder shall be treated as having transferred to such corporation his pro rata share of all the assets of the S corporation."

(b) WINDFALL PROFIT TAX.—

(1) Paragraph (1) of section 4996(a) (defining producer) is amended by adding at the end thereof the following new subparagraph:

"(C) SUBCHAPTER S CORPORATIONS.—

"(i) IN GENERAL.—If (but for this subparagraph) an S corporation would be treated as a producer of any crude oil—

"(I) such crude oil shall be allocated among the shareholders of such corporation, and

"(II) any shareholder to whom such crude oil is allocated (and not the S corporation) shall be treated as the producer of such crude oil.

"(ii) ALLOCATION.—Except to the extent otherwise provided in regulations, any allocation under clause (i)(I) shall be determined on the basis of the shareholder's pro rata share (as determined under section 1377(a)) of the income of the corporation."

(2) Section 4992 (relating to independent producer oil) is amended by adding at the end thereof the following new subsection:

"(f) S CORPORATION TREATED AS PARTNERSHIP.—For purposes of subsections (d) and (e)—

"(1) an S corporation shall be treated as a partnership, and

"(2) the shareholders of the S corporation shall be treated as partners of such partnership."

(c) USED PROPERTY FOR PURPOSES OF INVESTMENT CREDIT (SECTION 48(c)).—Subparagraph (D) of section 48(c)(2) (relating to partnerships) is amended—

(1) by adding at the end thereof the following new sentence: "A similar rule shall apply in the case of an S corporation and its shareholders.", and

(2) by striking out "PARTNERSHIPS" in the subparagraph heading and inserting in lieu thereof "PARTNERSHIPS AND S CORPORATIONS".

(d) INCOME FROM DISCHARGE OF INDEBTEDNESS (SECTION 108).—Paragraph (6) of section 108(d) (relating to application of section at partner level) is amended to read as follows:

"(6) SUBSECTIONS (a), (b), AND (c) TO BE APPLIED AT PARTNER LEVEL OR S CORPORATION SHAREHOLDER LEVEL.—In the case of a partnership, subsections (a), (b), and (c) shall be applied at the partner level. In the case of an S corporation, subsections (a), (b), and (c) shall be applied at the shareholder level."

(e) ELECTION TO EXPENSE CERTAIN DEPRECIABLE BUSINESS ASSETS (SECTION 179).—Paragraph (8) of section 179(d) (relating to dollar limitation in the case of partnerships) is amended—

(1) by adding at the end thereof the following new sentence: "A similar rule shall apply in the case of an S corporation and its shareholders.", and

(2) by striking out "PARTNERSHIPS" in the paragraph heading and inserting in lieu thereof "PARTNERSHIPS AND S CORPORATIONS".

(f) AMORTIZATION OF REFORESTATION EXPENDITURES (SECTION 194).—Subparagraph (B) of section 194(b)(2) (relating to partnerships) is amended—

(1) by adding at the end thereof the following new sentence: "A similar rule shall apply in the case of an S corporation and its shareholders.", and

(2) by striking out "PARTNERSHIPS" in the subparagraph heading and inserting in lieu thereof "PARTNERSHIPS AND S CORPORATIONS".

(g) TREATMENT OF LOSSES AND UNPAID EXPENSES AND INTEREST IN THE CASE OF TRANSACTIONS BETWEEN S CORPORATIONS AND CERTAIN RELATED ENTITIES (SECTION 267(b)).—

(1) Subsection (b) of section 267 (relating to losses, expenses, and interest with respect to transactions between related taxpayers) is amended by adding at the end thereof the following new paragraphs:

"(10) An S corporation and a partnership if the same persons own—

"(A) more than 50 percent in value of the outstanding stock of the S corporation, and

"(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

"(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

"(12) An S corporation and a C corporation, if the same individual owns more than 50 percent in value of the outstanding stock of each corporation."

(2) Section 267 is amended by adding at the end thereof the following new subsection:

"(f) SPECIAL RULES FOR UNPAID EXPENSES AND INTEREST OF S CORPORATIONS.—

"(1) IN GENERAL.—In the case of any amount paid or incurred by an S corporation, if—

"(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and

"(B) at the close of the taxable year of the S corporation for which (but for this paragraph) the amount would be deductible under section 162, 212, or 163, both the S corporation and the person to whom the payment is to be paid are persons specified in one of the paragraphs of subsection (b),

then no deduction shall be allowed in respect of expenses otherwise deductible under section 162 or 212, or of interest otherwise deductible under section 163, before the day as of which the amount thereof is includible in the gross income of the person to whom the payment is made.

"(2) CERTAIN SHAREHOLDERS, ETC., TREATED AS RELATED PERSONS.—For purposes of applying paragraph (1)—

"(A) an S corporation,

"(B) any person who owns, directly or indirectly, 2 percent or more in value of the outstanding stock of such corporation, and

"(C) any person related (within the meaning of subsection (b) of this section or section 707(b)(1)(A)) to a person described in subparagraph (B),

shall be treated as persons specified in a paragraph of subsection (b).

"(3) SUBSECTION (a)(2) NOT TO APPLY.—Subsection (a)(2) shall not apply to any amount paid or incurred by an S corporation."

(3) Subsection (b) of section 267 is amended by striking out "or" at the end of paragraph (8), and by striking out the period at the end of paragraph (9) and inserting in lieu thereof a semicolon.

SEC. 4. TECHNICAL AND CONFORMING AMENDMENTS.

(a) Technical Amendments.—

(1) Section 44D(d)(9).—Paragraph (9) of section 44D(d) (relating to pass-thru in the case of subchapter S corporations, etc.) is amended to read as follows:

"(9) Pass-thru in the case of estates and trusts.—Under regulations prescribed by the Secretary, rules similar to the rules of subsection (d) of section 52 shall apply."

(2) Section 44E(d)(5).—Paragraph (5) of section 44E(d) (relating to pass-thru in the case of subchapter S corporations, etc.) is amended to read as follows:

"(5) Pass-thru in the case of estates and trusts.—Under regulations prescribed by the Secretary, rules similar to the rules of subsection (d) of section 52 shall apply."

(3) Section 44F.—

(A) Subparagraph (A) of section 44F(f)(2) (relating to pass-thru in the case of subchapter S corporations, etc.) is amended to read as follows:

"(A) Pass-thru in the case of estates and trusts.—Under regulations prescribed by the Secretary, rules similar to the rules of subsection (d) of section 52 shall apply."

(B) Clause (iv) of section 44F(g)(1)(B) is amended by striking out "an electing small business corporation (within the meaning of section 1371(b))" and inserting in lieu thereof "an S corporation".

(4) SECTION 46(a)(4).—The second sentence of paragraph (4) of section 46(a) (defining liability for tax) is amended by striking out "section 1378 (relating to tax on certain capital gains of subchapter S corporations)," and inserting in lieu thereof "section 1374 (relating to tax on certain capital gains of S corporations),".

(5) SECTION 46(c)(8)(C).—Subparagraph (C) of section 46(c)(8) (relating to special rules for partnerships and subchapter S corporations) is amended by striking out "electing small business corporation (within the meaning of section 1371(b))" and inserting in lieu thereof "S corporation".

(6) SECTION 46(e)(3).—Paragraph (3) of section 46(e) (relating to noncorporate lessors) is amended by striking out "an electing small business corporation (as defined in section 1371)" and inserting in lieu thereof "an S corporation".

(7) SECTION 48(e).—Subsection (e) of section 48 (relating to subchapter S corporations) is hereby repealed.

(8) SECTION 48(k)(5)(D)(i).—The second sentence of clause (i) of section 48(k)(5)(D) (relating to allocation of direct production costs) is amended by striking out "an electing small business corporation (within the meaning of section 1371)" and inserting in lieu thereof "an S corporation".

(9) SECTION 50A(a)(3).—The second sentence of paragraph (3) of section 50A(a) (defining liability for tax) is amended by striking out "section 1378 (relating to tax on certain capital gains of subchapter S corporations)," and inserting in lieu thereof "section 1374 (relating to tax on certain capital gains of S corporations),".

(10) SECTION 50B(d).—Subsection (d) of section 50B (relating to subchapter S corporations) is hereby repealed.

(11) SECTION 52(d).—Section 52 is amended by striking out subsection (d) and by redesignating subsections (e) and (f) as subsections (d) and (e), respectively.

(12) SECTION 53(a).—The second sentence of subsection (a) of section 53 (relating to limitation based on amount of tax) is amended by striking out "section 1378 (relating to tax on certain capital gains of subchapter S corporations)," and inserting in lieu thereof

"section 1374 (relating to tax on certain capital gains of S corporations),".

(13) SECTION 57(a).—The next to the last sentence of section 57(a) (defining items of tax preference) is amended by striking out "an electing small business corporation (as defined in section 1371(b)) and".

(14) SECTION 58(d).—Subsection (d) of section 58 (relating to electing small business corporations and their shareholders) is amended to read as follows:

"(d) CERTAIN CAPITAL GAINS OF S CORPORATIONS.—If for a taxable year of an S corporation a tax is imposed on the income of such corporation under section 1374, such corporation shall be subject to the tax imposed by section 56, but computed only with reference to the item of tax preference set forth in section 57(a)(9)(B) to the extent attributable to gains subject to the tax imposed by section 1374."

(15) SECTION 62(9).—Paragraph (9) of section 62 (relating to pension, etc., plans of an electing small business corporation) is hereby repealed.

(16) SECTION 163(d)(4).—Paragraph (4) of section 163(d) (relating to limitation on interest on investment indebtedness) is amended by striking out subparagraphs (B) and (C) and redesignating subparagraph (D) as subparagraph (B).

(17) SECTION 168(f)(8)(B).—Clause (i) of section 168(f)(8)(B) (relating to special rules for leases) is amended by striking out "an electing small business corporation (within the meaning of section 1371(b))" and inserting in lieu thereof "an S corporation".

(18) SECTION 170(e).—

(A) Subparagraph (A) of section 170(e)(3) (defining qualified contributions) is amended by striking out "an electing small business corporation within the meaning of section 1371(b))" and inserting in lieu thereof "an S corporation)".

(B) Clause (i) of section 170(e)(4)(D) is amended to read as follows:

"(i) an S corporation,".

(19) SECTION 172(f).—Subsection (f) of section 172 (relating to disallowance of net operating loss of electing small business corporations) is hereby repealed.

(20) SECTION 183(a).—Subsection (a) of section 183 (relating to activities not engaged in for profit) is amended by striking out "an electing small business corporation (as defined in section 1371(b))" and inserting in lieu thereof "an S corporation".

(21) SECTION 189(a).—The second sentence of subsection (a) of section 189 (relating to amortization

of real property, construction period, and taxes) is amended by striking out "an electing small business corporation (as defined in section 1371(b))," and inserting in lieu thereof "an S corporation,".

(22) SECTION 280(a).—The second sentence of subsection (a) of section 280 (relating to certain expenditures incurred in production of films, books, records, or similar property) is amended by striking out "an electing small business corporation (as defined in section 1371(b))," and inserting in lieu thereof "an S corporation,".

(23) SECTION 280A.—

(A) Subsection (a) of section 280A (relating to disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.) is amended by striking out "an electing small business corporation," and inserting in lieu thereof "an S corporation,".

(B) Paragraph (1) of section 280A(e) is amended by striking out "an electing small business corporation" and inserting in lieu thereof "an S corporation".

(C) Paragraph (2) of section 280A(f) is amended to read as follows:

"(2) PERSONAL USE BY SHAREHOLDERS OF S CORPORATION.—In the case of an S corporation, subparagraphs (A) and (B) of subsection (d)(2) shall be applied by substituting 'any shareholder of the S corporation' for 'the taxpayer' each place it appears."

(24) SECTION 401.—Clause (ii) of section 401(j)(5)(C) is amended by striking out "the electing small business corporation" and inserting in lieu thereof "the S corporation".

(25) SECTION 447(C)(1).—Paragraph (1) of section 447(c) (relating to exception for small business and family corporations) is amended to read as follows:

"(1) an S corporation,".

(26) SECTION 464(C)(1).—Paragraph (1) of section 464(c) (defining farming syndicate) is amended by striking out "an electing small business corporation (as defined in section 1371(b))" each place it appears and inserting in lieu thereof "an S corporation".

(27) SECTION 465.—

(A) Paragraph (1) of section 465(a) (relating to deductions limited to amount at risk) is amended by adding "and" at the end of subparagraph (A), by striking out subparagraph (B), and by redesignating subparagraph (C) as subparagraph (B).

(B) Paragraph (3) of section 465(a) is amended—

(i) by striking out "paragraph (1)(C)" and inserting in lieu thereof "paragraph (1)(B)", and

(ii) by striking out "PARAGRAPH (1)(C)" in the paragraph heading and inserting in lieu thereof "PARAGRAPH (1)(B)".

(C) The last sentence of paragraph (2) of section 465(c) is amended—

(i) by striking out "an electing small business corporation" the first place it appears and inserting in lieu thereof "an S corporation", and

(ii) by striking out "an electing small business corporation" the second place it appears and inserting in lieu thereof "the S corporation".

(D) Clause (ii) of section 465(c)(3)(B) is amended by striking out "electing small business corporation (as defined in section 1371(b))" and inserting in lieu thereof "an S corporation".

(E) Subparagraph (A) of section 465(c)(4) is amended by striking out "subsection (a)(1)(C)" and inserting in lieu thereof "subsection (a)(1)(B)".

(28) SECTION 992(d)(7).—Paragraph (7) of section 992(d) (relating to corporations not eligible to be a DISC) is amended to read as follows:

"(7) an S corporation."

(29) SECTION 1016(a)(18).—Paragraph (18) of section 1016(a) (relating to adjustments to basis) is amended to read as follows:

"(18) to the extent provided in section 1367 in the case of stock of, and indebtedness owed to, shareholders of an S corporation;".

(30) SECTION 1101(a)(3)(D).—Subparagraph (D) of section 1101(a)(3) (relating to non-pro rata distributions from certain closely held corporations) is amended by striking out "section 1371(a)(1)" and inserting in lieu thereof "section 1361(b)(1)(A)".

(31) SECTION 1212(a).—Subsection (a) of section 1212 (relating to capital loss carrybacks and carryovers of corporations) is amended by striking out paragraph (3) and by redesignating paragraph (4) as paragraph (3).

(32) SECTION 1251(b)(2)(B).—

(A) Subparagraph (B) of section 1251(b)(2) (relating to excess deductions account) is amended—

(i) by striking out "an electing small business corporation (as defined in section 1371(b))," and inserting in lieu thereof "an S corporation,", and

(ii) by striking out "electing small business corporation" each place it appears in the second and third sentences and inserting in lieu thereof "S corporation".

(B) Subparagraph (D) of section 1251(d)(2) is amended by striking out "an electing small business corporation" and inserting in lieu thereof "an S corporation".

(33) SECTION 1254(b)(2).—Paragraph (2) of section 1254(b) (relating to special rules for gain from dispositions of interest in oil, gas, or geothermal property) is amended by striking out "an electing small business corporation (as defined in section 1371(b))," and inserting in lieu thereof "an S corporation,".

(34) SECTION 1256(e)(3)(B).—Subparagraph (B) of section 1256(e)(3) (defining syndicate) is amended by striking out "an electing small business corporation

within the meaning of section 1371(b)" and inserting in lieu thereof "an S corporation".

(35) SECTION 6037.—

(A) Section 6037 (relating to return of electing small business corporation) is amended—

(i) by striking out "Every electing small business corporation (as defined in section 1371(b))" and inserting in lieu thereof "Every S corporation",

(ii) by striking out "and such other information" and inserting in lieu thereof "each shareholder's pro rata share of each item of the corporation for the taxable year, and such other information", and

(iii) by striking out "**ELECTING SMALL BUSINESS CORPORATION**" in the section heading and inserting in lieu thereof "**S CORPORATION**".

(B) The table of sections for subpart A of part III of subchapter A of chapter 61 is amended by striking out "electing small business corporation" in the item relating to section 6037 and inserting in lieu thereof "S corporation".

(36) SECTION 6042(b)(2).—Paragraph (2) of section 6042(b) (defining dividend) is amended to read as follows:

"(2) EXCEPTIONS.—For purposes of this section, to the extent provided in regulations prescribed by the Secretary, the term 'dividend' does not include any distribution or payment—

"(A) by a foreign corporation, or

"(B) to a foreign corporation, a nonresident alien, or a partnership not engaged in a trade or business in the United States and composed in whole or in part of nonresident aliens."

(37) SECTION 6362(f)(7).—Paragraph (7) of section 6362(f) (relating to partnerships, trusts, subchapter S corporations, and other conduit entities) is amended—

(A) by striking out "electing small business corporations (within the meaning of section 1371(a))" in subparagraph (D) and inserting in lieu thereof "S corporations", and

(B) by striking out "SUBCHAPTER S CORPORATIONS," in the paragraph heading.

(b) CLERICAL AMENDMENT.—The table of subchapters for chapter 1 is amended by striking out the item relating to subchapter S and inserting in lieu thereof the following:

"SUBCHAPTER S. Tax treatment of S corporations and their shareholders."

SEC. 5. EFFECTIVE DATES.

(a) In General.—Except as provided in subsection (b), the amendments made by this Act shall apply to taxable years beginning after December 31, 1982.

(b) Transitional Rule.—In the case of any plan in existence on the date of enactment of this Act, for taxable years or plan years (whichever is appropriate) beginning before January 1, 1985—

(1) section 1372 of the Internal Revenue Code of 1954 (as added by this Act) shall not apply, but

(2) sections 1379 and 62(9) of such Code (as in effect before the date of the enactment of this Act) shall apply.

DESCRIPTION OF S. 2350
(SUBCHAPTER S REVISION ACT OF 1982)

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

This pamphlet provides a description of S. 2350 (introduced by Chairman Dole and Senator Long), the Subchapter S Revision Act of 1982. The Senate Finance Committee has scheduled a public hearing on the bill on September 10, 1982.

The first part of the pamphlet is a background on subchapter S of the Code. The second part is a summary of S. 2350. This is followed in part three by a more detailed description of present law and of the provisions of the bill. Part four describes other Congressional action on this matter. Finally, part five is a statement on the estimated revenue effect of the bill.

I. BACKGROUND

Legislative background

For tax purposes, a corporation generally is treated as a separate entity, apart from its shareholders. That is, income earned by the corporation is taxed to it, and distributions from the corporation (either as dividends or in liquidation) also are taxed to the shareholders. A partnership, on the other hand, is not treated as a taxable entity for income tax purposes. Instead, the income of the partnership, whether distributed or not, is taxed to the partners, and distributions by the partnership are generally tax-free.

In many instances, businesses, especially small businesses, may wish to incorporate for business reasons (for example, to obtain limited liability), but would prefer not to have corporate tax treatment. The noncorporate tax treatment may be preferred where the owners wish to have corporate losses pass through to their individual returns (or where most of the owners are taxed at individual income tax rates which are lower than the applicable corporate rate). Alternatively, even if the owners are taxed at individual rates higher than the corporate rate, they may prefer noncorporate tax treatment—assuming they expect to withdraw amounts of the income from the business—in order to avoid the dividend tax on corporate distributions.

In light of these considerations, the Congress enacted subchapter S of the Internal Revenue Code (secs. 1371 through 1379) in 1958. The objectives of the legislation were to minimize the effect of Federal income taxes on choices of the form of business organization, and to permit the incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and the shareholder levels (S. Rept. No. 1983, 85th Cong., 2d Sess. 87 (1958)).

Because of the passthrough of income and loss to the shareholders of a subchapter S corporation, subchapter S is often described as a method of taxing corporations as if they were partnerships. In fact, there are a number of significant differences in tax treatment under the partnership provisions (subchapter K) and the subchapter S provisions. For example, the partnership provisions provide a complete passthrough of the tax characteristics of the items of income and deduction incurred by the partnership, while the subchapter S provisions do not provide such a passthrough (except for capital gains). Under the partnership provisions, a distribution that does not exceed a partner's basis in his or her partnership interest generally is treated as a nontaxable return of capital. In many instances, a similar distribution to a subchapter S shareholder is treated as a taxable distribution. Under the partnership provisions, a loss carryover is allowed to the extent that losses exceed a partner's basis in his or her partnership interest as of the close of the year; in the comparable subchapter S situation, no loss carryover is available.

The experience of taxpayers with subchapter S attests to many "traps" for those not knowledgeable about its technical provisions. These unintended adverse tax consequences most often involve (1) unintentional violation of the continuing eligibility rules, resulting in retroactive terminations of elections; (2) the making of taxable distributions which were intended to be tax-free distributions of previously taxed income; and (3) a shareholder's having an insufficient basis to absorb his or her share of the corporation's loss, resulting in the permanent disallowance of that part of the loss.

The history of subchapter S also indicates that knowledgeable taxpayers may have derived some unintended benefits from the subchapter S provisions. Examples of such benefits include the deferral of income resulting from the selection of a taxable year for the corporation which is different from that of the majority of its shareholders, and the use of the retroactive termination provisions of subchapter S to prevent the passthrough of a substantial amount of income to the shareholders.

S. 2350

Since the enactment of subchapter S in 1958, various studies undertaken by government and professional groups have recommended revisions of subchapter S to simplify and modify its operation. A study by the staff of the Joint Committee on Taxation to simplify subchapter S was published on April 30, 1980.[1] S. 2350, like an identical House bill (H.R. 6055), is based largely on the recommendations of that study.[2] In addition, comments have been received from the Treasury Department, the staffs of the tax-writing committees, the tax section of the American Bar Association, the Federal tax division of the American Institute of Certified Public Accountants, and other professional groups and individuals. These comments have been taken into account in developing the introduced bills.

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[1] Commitee Print, Joint Committee on Taxation, "Staff Recommendations for Simplification of Tax Rules Relating to Subchapter S Corporations" (JCS-24-80), Apr. 30, 1980.

[2] The bill would vary the revisions recommended in the staff study in a number of respects. Among such variations, for example, would be the retention of a limitation on gross receipts from foreign sources by a subchapter S corporation and retention of an investment income limitation on corporations with accumulated earnings and profits.

II. SUMMARY

In general, S. 2350 (the Subchapter S Revision Act of 1982) is intended to simplify and modify the tax rules relating to eligibility for subchapter S status and the operation of subchapter S corporations. This would be accomplished by removing eligibility restrictions that appear unnecessary and by revising the rules relating to income, distributions, etc., that tend to create traps for the unwary. The principal changes that would be made by the bill are summarized below.

Eligibility

With respect to initial and continued eligibility of a corporation for subchapter S treatment, the following changes would be made:

(1) The number of permitted shareholders would be increased from 25 to 35;

(2) Differences in voting rights in common stock would not violate the one-class-of-stock requirement;

(3) The present law rule which automatically terminates a corporation's subchapter S election if more than 20 percent of a corporation's gross receipts for any taxable year are passive investment income would be eliminated for corporations which do not have accumulated earnings and profits at the close of the taxable year; and

(4) A person who becomes a shareholder of a subchapter S corporation after the initial election of subchapter S status would not have the power to terminate the election by affirmatively refusing to consent to the election. Accordingly, the new shareholder would be bound by the initial election until the election is otherwise terminated.

Elections, revocations, and terminations

The bill would provide that an election made on or before the fifteenth day of the third month of the taxable year would be effective for the entire taxable year if all persons who held stock in the corporation during that year were individuals, estates, and qualified trusts, and if all persons who held stock in the corporation at any time during the year up to the time the election is made consent to the election. If these requirements are not met, or if the election is made later than the fifteenth day of the third month of the taxable year, it would not be effective until the subsequent taxable year.

An event occurring during the taxable year which causes a corporation to fail to meet the definition of an eligible corporation would terminate the election as of the day on which the event occurred (rather than as of the first day of the taxable year in which the event occurred, as under present law). To minimize the effect of inadvertent termination, the bill would provide that the Internal Revenue Service may waive the terminating event so that the corporation may continue to be a subchapter S corporation notwithstanding that event.

The bill would provide that an election could be revoked by those shareholders holding a majority of the corporation's voting stock (as contrasted with the current rule, which requires all shareholders to consent to a revocation). The present law rule allowing a revocation filed during the first month of the taxable year to be effective for that entire taxable year would be modified so that such a retroactive revocation may be filed on or before the fifteenth day of the third month of the taxable year.

Passthrough of income, etc.

The bill would provide that the character of items of income, deduction, loss, and credits of the corporation would pass through to the shareholders in the same general manner as the character of such items of a partnership passes through to partners. Thus, for example, such items as tax-exempt interest, capital gains and losses, percentage depletion, the source of allocation of foreign income or loss, and foreign income taxes would pass through and retain their character in the hands of shareholders.

As is the case under present law with respect to losses, income would be passed through and allocated to shareholders on a per-share, per-day basis.

Selection of taxable year

Under the bill, rules generally similar to those applicable to partnerships would apply to the selection of a taxable year for a subchapter S corporation. The taxable year of a corporation which makes a subchapter S election would be required to be either the calendar year, or any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Treasury Department.

These rules also would apply to corporations currently operating under subchapter S. However, a corporation with a subchapter S election in effect on December 31, 1982, could continue its current taxable year so long as 50 percent or more of the outstanding stock in the corporation on that date continue to be owned by the same shareholder. For purposes of this transitional rule, transfers of stock through inheritance would not be considered changes in ownership.

Carryforward of loss

Under the bill, a subchapter S shareholder would be entitled to carry forward a loss to the extent that the amount of the loss passed through for the year exceeds the aggregate amount of the bases in his subchapter S stock and loans to the corporation. The loss carried forward could be deducted only by that shareholder if and when the basis in his or her stock of, or loans to, the corporation is restored.

Distribution

The rules relating to distributions from subchapter S corporations would be extensively revised.

Under the new rules, a corporation would not have earnings and profits attributable to any taxable year beginning after the date of enactment if a subchapter S election is in effect for that year. For corporations with no earnings and profits, the amount of the distribution (generally, cash plus the fair market value of property) would be tax-free and would reduce the shareholder's basis in his or her stock. To the extent that the amount of the distribution exceeded the amount of the basis in the stock, capital gains would result.

For corporations with accumulated earnings and profits, the distribution would be treated as a distribution by a corporation without earnings and profits to the extent of the shareholder's portion of the undistributed amount of subchapter S gross income less deductible expenses (an "accumulated adjustment account"). Any amount in excess of the accumulated adjustment account would be treated under the usual corporate rules, first as a distribution out of accumulated earnings and profits to the extent thereof.

Under the bill, both taxable and nontaxable income and deductible and nondeductible expenses would serve, respectively, to increase and decrease the subchapter S shareholder's basis in his or her stock in, and loans to, the corporation. These rules are generally analogous to those provided for partnerships. Also, unlike present law, basis would be restored to debt obligations as well as stock. Restoration of basis would be made first to debt (to the extent of prior reductions) and then to stock. Under the bill, gain would be recognized by a subchapter S corporation upon nonliquidating distributions of appreciated property.

Qualified plans and fringe benefits

Under the bill, rules similar to the partnership tax rules would apply to pension and profit-sharing plans of a subchapter S corporation and to employee fringe benefits. For this purpose, persons owning two percent or more of the corporate stock would be treated as partners and a 10-percent owner would be treated as an owner-employee.

Treatment of transactions between corporation and related parties

Under the bill, amounts accruing to any cash-basis shareholder owning two percent or more of the corporation's stock would be deductible only when paid.

Administration

The bill would provide that the items of subchapter S income, deductions, and credits would be determined in audit and judicial proceedings at the corporate level rather than at the shareholder level. Shareholders would be given notice of, and the opportunity to participate in, Internal Revenue Service proceedings with the corporation.

Effective date

The bill generally would be effective for taxable years beginning after December 31, 1982.

III. PRESENT LAW AND DESCRIPTION OF BILL

A. Eligibility for Subchapter S Treatment

Present Law

Under present law, a corporation is eligible to elect and continue subchapter S status only if it (i) has no more than 25 shareholders,[1] (ii) has no shareholder other than an individual who is a citizen or resident of the United States, an estate, or certain types of trusts[2] (grantor trusts, voting trusts, testamentary trusts for a 60-day period, and certain "qualified subchapter S trusts"), (iii) is not a member of an "affiliated group" of corporations, and (iv) has only one class of stock.

A valid subchapter S election will be terminated if a new shareholder affirmatively refuses to consent to the election, if the election is revoked by all the shareholders, if more than 80 percent of the corporation's gross receipts for any taxable year are derived from sources outside the United States, or if more than 20 percent of the gross receipts for any taxable year consist of royalties, rents, interests, dividends, annuities, or gain on the sale or exchange of stock or securities.

Explanation of Provisions

1. Permitted number of shareholders (sec. 1361(b)(1)(A))[3]

The number of permitted shareholders would be increased from 25 to 35. This number would correspond to the private placement exemption under Federal securities law.[4]

2. One class of stock requirement (secs. 1361(b)(1)(D) and (c)(4))

The outstanding shares of the corporation must continue to be identical as the rights of the holders in the profits and in the assets of the corporation. However, unlike present law, differences in voting rights among shares of common stock would be permitted by the bill.[5]

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[1] The maximum number was set at 10 when subchapter S was enacted and was increased to 15 for certain corporations by the Tax Reform Act of 1976. The Revenue Act of 1978 set the limit at 15 for all corporations. The Economic Recovery Tax Act of 1981 increased the limit to 25.

For purposes of determining the number of shareholders, a husband and wife are treated as one shareholder.

[2] Trusts were not eligible to be shareholders under subchapter S, as enacted. Voting trusts, grantor trusts, and testamentary trusts became eligible shareholders under the Tax Reform Act of 1976. The Economic Recovery Tax Act of 1981 permitted as shareholders, trusts to which sec. 678 applies (under which a person other than the grantor is treated as the owner), and "qualified subchapter S trusts" (i.e., certain trusts in which the income beneficiary elects to be taxed, as the owner).

[3] References are to sections of the Internal Revenue Code of 1954 as proposed to be amended by S. 2350.

[4] Rule 506 of Regulation D issued pursuant to sec. 4(2) of the Securities Act of 1933.

3. Affiliated group (secs. 1361(b)(2)(A) and (c)(5))

The bill would retain the rule that a member of an affiliated group of corporations is not eligible for subchapter S status; that is, an electing corporation cannot own 80 percent or more of the stock of another corporation unless the other corporation has not begun business and has no taxable income. The bill would provide that this rule also applies to the holding of any subsidiary, whether or not the corporation would be eligible to file a consolidated return with its subsidiary.

4. Eligible shareholders (secs. 1361(b)(1)(B), (c)(2), (c)(3), and (d))

Present law would be retained. Only individuals (other than nonresident aliens), estates, and certain trusts would be eligible to hold stock in the corporation. Foreign trusts, like foreign corporations and nonresident aliens, would not be eligible shareholders.

5. Source of income (secs. 1361(b)(2) and 1362(d)(3) and (4))

The provision of present law that a subchapter S corporation may not derive more than 80 percent of its gross receipts from sources outside the United States would be retained.

The bill would generally repeal the requirement that a subchapter S corporation may not have more than 20 percent of its gross income in the form of passive investment income. However, that requirement would continue to apply to those corporations which have, at the close of the taxable year, accumulated earnings and profits from years prior to electing the new subchapter S provisions.

In addition, a financial institution which is allowed a deduction for bad debts under section 585 or 593, or an insurance company subject to tax under the special insurance company rules of the Code, could not elect subchapter S.[6] These corporations are entitled to certain deductions not generally allowed to individuals. Many of these corporations are not eligible for subchapter S treatment under present law because of the passive income rules.

Possession corporations, DISC's, and former DISC's would continue to be ineligible to elect subchapter S.[7]

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[5] S. 2350 would not amend the present law rule determining whether a purported debt instrument constitutes a second class of stock. The courts have ruled certain instruments are permissible under present law where their existence offered no tax avoidance possibilities, notwithstanding that under traditional tax concepts these instruments would have normally been considered stock for tax purposes (see, e.g., *Portage Plastics Co.* v. *United States*, 486 F. 2d 632 (7th Cir. 1973), and the cases cited therein). The Internal Revenue Service has announced that it will not litigate cases factually similar to the facts in those cases (TIR–1248 (July 27, 1973)).

In addition, under present law, a subchapter S corporation may have outstanding options and warrants to acquire stock or debentures that are convertible into stock (Rev. Rul. 67–269, 1967–2 C.B. 298).

[6] The Internal Revenue Service has ruled that life insurance companies may not qualify as subchapter S corporations under present law (Rev. Rul. 74–344, 1974–2 C.B. 273). The Service has also ruled that stock casualty insurance companies taxable under sec. 831(a) may elect subchapter S treatment (Rev. Rul. 74–437, 1974–2 C.B. 274).

[7] Regulated investment companies and real estate investment trusts would continue to be ineligible because of the numerical shareholder limitations.

B. Election, Revocation, and Termination

Present Law

Under present law, an election to be taxed as a subchapter S corporaton may be made for any taxable year at any time during the preceding taxable year or at any time during the first 75 days of the taxable year.[8] An election continues in effect for subsequent taxable years until it is terminated.

In order for an election to be effective, each shareholder on the day the election is made must consent to the election. If a subchapter S election is terminated, a new election cannot be made by the corporation (or its successor) for any year prior to its fifth taxable year beginning after the taxable year during which the termination is effective, unless the Internal Revenue Service consents to an earlier election.

Under present law, the termination of an election is generally retroactive to the first day of the taxable year in which the terminating event occurred. A termination automatically occurs if the corporation fails to meet any of the eligibility requirements for subchapter S treatment. An election also terminates if all the shareholders of the corporation consent to a revocation. A revocation generally is effective for the following taxable year. Finally, an election can be terminated if a new shareholder affirmatively refuses to consent to the election on or before the 60th day after he or she acquired the stock.

Explanation of Provisions

1. Making an election (secs. 1362(a) and (b))

An election made on or before the fifteenth day of the third month of a corporation's taxable year would be effective for the entire taxable year if the corporation meets all the eligibility requirements (including shareholder eligibility requirements) for that entire taxable year, and if all persons who held stock in the corporation at any time during the portion of the year before the election was made consented to the election.

If the eligibility requirements are not met for the entire year in which the election is made, if consents of all shareholders who had disposed of their stock prior to the making of the election are not obtained, or if the election is made after the fifteenth day of the third month of the year, the election would not become effective until the next taxable year. This rule would eliminate any problem of allocation of income and loss with respect to pre-election stockholders who either were ineligible to hold subchapter S corporation stock or did not consent to the election.

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[8] Prior to an amendment made by the Revenue Act of 1978, the election was required to be made during the two-month period beginning one month before the start of the taxable year.

2. *Termination of election (secs. 1362 (d), (e), and (g))*

Generally, specific events during the taxable year which cause a corporation to fail to meet the definition of a small business corporation would result in a termination of the election as of the date on which the event occurred (rather than as of the first day of the taxable year, as under present law). The events causing disqualification would be: (1) exceeding the maximum allowable number of shareholders; (2) transfer of stock to a corporation, partnership, ineligible trust, or nonresident alien; (3) the creation of a class of stock other than the voting and nonvoting common stock allowed; and (4) the acquisition of a subsidiary (other than certain nonoperating subsidiaries).

The day before the day on which the terminating event occurs would be treated as the last day of a short subchapter S taxable year, and the day on which the terminating event occurs would be treated as the first day of a short regular (i.e., subchapter C) taxable year. There would be no requirement that the books of a corporation be closed as of the termination date. Instead, the corporation would be required to allocate the income or loss for the entire year (i.e., both short years) on a daily proration basis.

However, the corporation could elect, with the consent of all persons who were shareholders during the short subchapter S year, to report the taxable income or loss on each return (subchapter S and subchapter C) on the basis of income or loss shown on the corporation's permanent records (including work papers). Under this method, items would be attributed to the short subchapter S and subchapter C years according to the time they were incurred or realized, as reflected in such records.

The short subchapter S and subchapter C taxable years would be treated as one year for purposes of carrying over previous subchapter C losses. The income allocated to the subchapter C taxable year would be subject to annualization for purposes of applying the corporate rate brackets. The return for the short subchapter S year would be due on the same date as the return for the short subchapter C year is due.

As under present law, if a corporation's election terminates because the foreign income limitation or the passive income limitation (to the extent still applicable) is violated for any taxable year, the election is terminated for that entire taxable year.

If an election is terminated, a new election cannot be made, without the consent of the Internal Revenue Service, for five taxable years (as under present law).

3. *Revocation of election (sec. 1362(d)(1))*

An election could be revoked only by action of shareholders holding more than one-half of the corporation's voting stock.

The present law rule allowing a revocation filed during the first month of the taxable year to be effective for that entire taxable year would be modified. Under the bill, a revocation filed up to and including the fifteenth day of the third month of the taxable year would be effective for the entire taxable year, unless a prospective effective date was specified. The period during which a retroactive revocation could be filed thus would correspond to the time period in which a retroactive election may be made. Revocations made after the fifteenth day of the third month of the taxable year would be effective on the first day of the following taxable year unless the revocation stated some other prospective date, in which case it would be effective as of the specified date.

Revocations which designate a prospective effective date would result in the splitting of the year into short subchapter S and subchapter C taxable years with the tax consequences as discussed above in connection with terminations.

A person becoming a shareholder of a subchapter S corporation after the initial election would not have the power to terminate the election by affimatively refusing to consent to the election. He or she would be bound by the initial election.

4. Inadvertent terminations (sec. 1362(f))

If the Internal Revenue Service determines that a corporation's subchapter S election was inadvertently terminated, the Service could waive the effect of the terminating event for any period if the corporation timely corrects the event, and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

C. Treatment of Income, Deductions, and Credits

Present Law

Under present law, a subchapter S corporation is not subject to the corporate income tax. An exception to this rule is the imposition of a capital gains tax on certain subchapter S corporations, in order to discourage the making of a "one-shot" subchapter S election.

Instead, the undistributed taxable income of the corporation is includible in gross income of the shareholders owning stock on the last day of the corporation's taxable year. Similar rules pass through the credits of the corporation to its shareholders. Any net operating loss of the corporation is passed through to the shareholders, based on each shareholder's pro rata share of ownership in the corporation during the taxable year. Specific items (such as charitable contributions), other than the long-term capital gain portion of income, do not pass through.

Income may be reallocated by the Internal Revenue Service among shareholders who are family members as necessary to reflect the value of services rendered.

A shareholder may deduct a loss only to the extent of the shareholder's adjusted basis in the stock of the corporation plus the shareholder's adjusted basis of any indebtedness of the corporation to the shareholder. Loses in excess of this limitation may not be carried over.

A shareholder's basis in the stock of the corporation is increased by the amount of undistributed taxable income taken into account, and decreased by the shareholder's share of the net operating loss passed through. Losses reduce basis in any indebtedness after the stock basis has been reduced to zero.

Explanation of Provisions

1. Treatment of corporations (secs. 1363(a), 1371(d), and 1374)

As under present law, a subchapter S corporation would not be subject to the corporate income tax, except for the present tax on capital gains. This tax, which is imposed to limit use of subchapter S on a temporary basis in order to pass capital gains through to shareholders, would continue.

Under the bill, the tax imposed under section 47 in the case of an early disposition of property on which an investment credit was claimed would be imposed on the corporation with respect to property purchased by the corporation prior to the effective date of the subchapter S election. The election would not be treated as a disposition of the property by the corporation.

2. Treatment of shareholders (secs. 1363(b) and (c), 1366, 1367, 1371(b), and 1373)

In general

The bill would set forth new rules for the taxation of income earned by, and the allowance of losses incurred by, subchapter S corporations. These rules generally follow the present law rules governing the taxation of partners with respect to items of partnership income and loss.

Computation of corporate items

A subchapter S corporation's taxable income would be computed under the same rules presently applicable to partnerships under section 703, except that the amortization of organization expenditures under section 248 would be an allowable deduction. As in the case of partnerships, deductions generally allowable to individuals would be allowed to subchapter S corporations. However, provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, would not apply. Items, the separate treatment which could affect the liability of any shareholder, would be treated separately.

Elections would generally be made at the corporate level, except for those elections which the partners of a partnership may make separately (such as the election to claim the foreign tax credit).

Passthrough of items

The following examples illustrate the operation of the bill's passthrough rules:

a. Capital gains and losses.—Gains or losses from sales or exchanges of capital assets would pass through to the shareholders as capital gains or losses. Net capital gains would no longer be offset by ordinary losses at the corporate level.

b. Section 1231 gains and losses.—The gains and losses on certain property used in a trade or business would be passed through separately and would be aggregated with the shareholder's other section 1231 gains and losses. Thus, section 1231 gains would no longer be aggregated with capital gains at the corporate level and passed through as capital gains.

c. Charitable deductions.—The corporate 10-percent limitation would no longer apply to contributions by the corporation. As in the case of partnerships, these deductions would retain their character as charitable contributions when passed through to the shareholders, at which level they would be subject to the individual limitations on deductibility.

d. Tax-exempt interest.—Tax-exempt interest would pass through to the shareholders as such and would increase the shareholders' basis in their subchapter S stock. Because of the limitation of the earnings and profits account (discussed in III–D, below), subsequent distributions by the corporation would not result in taxation of the tax-exempt income.

e. Foreign taxes.—Foreign taxes paid by the corporation would pass through as such to the shareholders, who would claim such taxes either as deductions or credits (subject to the applicable limitations). However, a subchapter S corporation would not be eligible for the foreign tax credit with respect to taxes paid by a foreign corporation in which the subchapter S corporation is a shareholder; therefore, these taxes would not pass through to its shareholders. Special foreign loss recapture provisions similar to those of section 904(f) would apply to a corporation electing out of subchapter S which had previously passed foreign losses through to its shareholders. Rules concerning the source of income, including the capital gains source rule of section 904(b), and the amount of creditable taxes, such as the rules of section 907(a), would apply at the shareholder level.

f. Credits.—As with partnerships, items involved in the determination of credits (such as the basis of section 38 property for purposes of computing amount of qualified investment eligible for the investment tax credit) would pass through to the subchapter S corporation's shareholders.

g. Depletion.—The present rules governing depletion with regard to partnership interests in minerals would apply to depletion of properties of a subchapter S corporation (see discussion in section III–F, below, for special rules in the case of oil and gas properties).

h. Foreign income and loss.—Domestic losses and foreign losses would pass through separately. If a corporation had foreign losses and domestic income, or vice versa, each would pass through separately to shareholders without aggregation at the corporate level.

i. Other items.—Limitations on the used property investment tax credit (sec. 48(c)), the expensing of certain depreciable business assets (sec. 179), and the amortization of reforestation expenditures (sec. 194) would apply at both the corporate level and shareholder level, as in the case of partnerships.

Carryovers from years in which the corporation was not a subchapter S corporation would not be allowed to the corporation while in subchapter S status.

Shareholder treatment of items

As with the partners of a partnership, each shareholder of a subchapter S corporation would take into account separately his or her pro rata share of items of income, deduction, credit, etc. of the corporation. These rules would parallel the partnership rules under section 702. Each shareholder's share of the items would be taken into account in the shareholder's taxable year in which the corporation's year ends.

For these purposes, a shareholder's pro rata share generally would be determined in the same manner as the present law rule for passing through net operating losses. In cases of transfers of subchapter S stock during the taxable year, income, losses, and credits would be allocated in essentially the same manner as when the election terminates during the year. Thus, the allocation would be made on a per-share, per-day basis unless the corporation, with the consent of its shareholders, elected to allocate according to its permanent records (including work papers).

A "conduit" rule for determining the character of items realized by the corporation and included in the shareholder's pro rata share would be the same as the partnership rule. Also, the "gross income" determinations made by a shareholder would parallel the partnership rule.

Under the bill, items taken into account by members of the family of a shareholder could be adjusted by the Internal Revenue Service as necessary to reflect reasonable compensation to the shareholder for services rendered or capital furnished to the corporation. Both the amount of compensation and the timing of the compensation could be so adjusted.

As under present law, a shareholder's allowable pro rata share of the corporation's loss would be limited to the sum of the shareholder's adjusted basis in the stock of the corporation plus the shareholder's adjusted basis of any indebtedness of the corporation to the shareholder. However, unlike present law, disallowed losses could be carried forward or allowed in any subsequent year in which the shareholder has adequate basis in such stock or debt.

Subsequent to a termination of a subchapter S election, these disallowed losses would be allowed if the shareholder's basis in his stock in the corporation is restored by the later of the following dates:

(1) One year after the effective date of the termination or the due date for the last subchapter S return, whichever is later; or

(2) 120 days after a determination that the corporation's subchapter S election had terminated for a previous year. (A determination would be defined as a court decision which becomes final, a closing agreement, or an agreement between the corporation and the Internal Revenue Service that the corporation failed to qualify.)

3. Basis adjustment (sec. 1367)

Under the bill, both taxable and nontaxable income and deductible and nondeductible expenses would serve, respectively, to increase and decrease a subchapter S shareholder's basis in the stock of the corporation.

These rules would be analogous to those provided for partnerships under section 705. Unlike the partnership rules, however, to the extent property distributions are treated as a return of basis, basis would be reduced by the fair market value of these properties (see section III-D, below). Any passthrough of income for a particular year (allocated according to the proportion of stock held in the corporation) would first increase the shareholder's basis in loans to the corporation to the extent the basis was previously reduced by the passthrough of losses.

D. Treatment of Corporate Distributions

Present Law

Under present law, the general rules applicable to distributions to shareholders by regular corporations apply to such distributions by subchapter S corporations. Under the normal corporate rules, distributions of cash or other property are treated as taxable dividends, at fair market value, to the extent the corporation has either current or accumulated earnings and profits. Distributions in excess of earnings and profits are tax-free up to the shareholder's basis in the stock, and any excess is then treated as gain from the sale of the stock.

In addition to the regular rules, special rules also apply to distributions by subchapter S corporations. These rules allow a corporation to make tax-free cash distributions within 2½ months after the close of the taxable year out of the prior year's undistributed taxable income to the extent of the shareholder's portion of that income (sec. 1375(f)). Also, cash distributions which are not distributions of the prior year's undistributed taxable income and which are in excess of current earnings and profits qualify as tax-free distributions of a shareholder's previously taxed income to the extent of that income (sec. 1375(d)). The right to receive previously taxed income is not transferable and terminates when the corporation's subchapter S election terminates.

Property distributions by subchapter S corporations are treated differently from cash distributions in that they do not reduce the amount of the current year's undistributed taxable income taxed to the shareholder and do not qualify as distributions of either undistributed taxable income or of previously taxed income. Also, property distributions reduce earnings and profits by an amount equal to the adjusted basis of the property distributed.

In summary, distributions of money have the following tax consequences in the following order: (1) a tax-free distribution of undistributed taxable income to the extent thereof, if made within 2½ months after the end of the corporation's taxable year; (2) a dividend to the extent of current earnings and profits; (3) a tax-free distribution to the extent of previously taxed income (a special rule reverses the order of items (2) and (3) in the case of certain accelerated depreciation); (4) a dividend to the extent of accumulated earnings and profits (the shareholder may elect to reverse the order of items (3) and (4)); (5) reduction in the shareholder's basis in the stock of the corporation; and (6) a taxable disposition of the stock.

Property distributions have the following tax consequences under present law: (1) A dividend distribution to the extent of either current or accumulated earnings and profits; (2) reduction in the shareholder's basis in the stock of the corporation; and (3) a taxable disposition of the stock.

Generally, distributions have no tax effect on the distributing corporation, except for distributions of LIFO inventory where the "LIFO reserve" is recaptured, or distributions of property where the liability exceeds basis, which results in gain to the extent of the excess (sec. 311(a), (b), and (c)).

Explanation of Provisions

1. Taxation of shareholders (secs. 1368 and 1371(c))

Under the bill, the amount of any distribution to a shareholder would equal the amount of cash distributed plus the fair market value of any property distributed, as under present law.

The amount of a distribution by a corporation without accumulated earnings and profits would be tax-free to the extent of the shareholder's basis in the stock. The distribution would be applied to reduce the shareholder's basis in his stock. To the extent the amount of the distribution exceeds basis, capital gains would result.

No post-1982 earnings of a subchapter S corporation would be considered earnings and profits for this purpose. Thus, under the bill, a corporation would not have earnings and profits attributable to any taxable year beginning after 1982 if a subchapter S election was in effect for that year. However, a corporation could have earnings and profits attributable to (1) taxable years for which an election was not in effect; (2) taxable years beginning prior to 1983 for which an election was in effect; and (3) a corporate acquisition which results in a carryover of earnings and profits under section 381.

A distribution by a subchapter S corporation with accumulated earnings and profits would be treated as if made by a subchapter S corporation with no earnings and profits up to the amount in the corporation's accumulated adjustment account (i.e., gross income less deductible expenses, not previously distributed).[9] Any excess would then be treated as a dividend up to the amount of accumulated earnings and profits; any residual amount would then be applied against the shareholder's remaining basis in his stock; and, finally, any remainder of the distribution would be treated as capital gain.

Thus, under the bill, shareholders of subchapter S corporations with accumulated earnings and profits generally would be assured of tax-free treatment with respect to distributions, regardless of when made, to the extent of the corporation's accumulated adjustment account.

The rules described above would apply to the transferee of stock in a subchapter S corporation regardless of the manner in which the transferee acquired the stock.

2. Treatment of corporation (sec. 1363(d))

Gain would be recognized by a subchapter S corporation on any distribution of appreciated property, other than distributions in complete liquidation of the corporation. This rule results from the combination of the elimination of earnings and profits for subchapter S years and the retention of the fair market value distribution rule. Without this rule, assets could be distributed tax-free (except for recapture in certain instances) and subsequently sold without income recognition to the selling shareholder because of the stepped-up fair market value basis.

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[9] The effect of excluding tax-exempt income from the accumulated adjustments account is to require accumulated earnings and profits to be distributed before tax-exempt income is considered distributed.

E. Taxable Year of Corporation

Present Law

Under present law, shareholders of a subchapter S corporation take into account undistributed taxable income and net operating losses for their taxable years in which the subchapter S taxable year ends. No special rules limit the taxable year which the corporation may select. As a result, a deferral of tax can result if a taxable year ending shortly after the end of the shareholder's taxable year is selected.

Explanation of Provision (sec. 1378)

Under the bill, the taxable year of a subchapter S corporation would be required to be either a year ending December 31, or any other taxable year for which it establishes a business purpose to the satisfaction of the Internal Revenue Service.

A corporation which is a subchapter S corporation during the taxable year which includes December 31, 1982, would be permitted to retain its existing taxable year so long as at least 50 percent of the stock in the corporation is owned by the same persons who owned such stock on December 31, 1982. However, to retain subchapter S status for taxable years beginning after the day on which more than 50 percent of its stock has changed ownership subsequent to December 31, 1982, the corporation would have to conform to the general taxable year rule and either use the calendar year or establish a business purpose for a different year. For these purposes, transfers of shares by reason of the shareholder's death would not be considered changes in ownership.

F. Other Rules

1. Treatment of pension and profit-sharing plans

Present Law

Under present law, a pension or profit-sharing plan of a subchapter S corporation is subject to special rules which are in addition to the tax-qualification requirements applicable to plans of other corporations. However, beginning in 1984, the Tax Equity and Fiscal Responsibility Act of 1982 generally eliminates the distinctions between the qualification rules of different types of entities.

Explanation of Provision (sec. 1372(a))

Under the bill, a pension or profit-sharing plan of a subchapter S corporation generally would be treated as an H.R. 10 plan under the tax qualification requirements of the Code and also for purposes of the other tax rules relating to qualified plans. (Because of the changes made by the Tax Equity and Fiscal Responsibility Act of 1982, this provision of the bill will become redundant after 1983.)

2. Treatment of fringe benefits

Present Law

Under present law, the statutory exemptions for fringe benefits applicable to shareholder-employees of regular corporations also apply in the case of subchapter S corporations. The benefits include the following:

(1) the $5,000 death benefit exclusion (sec. 101(b));

(2) the exclusion from income of amounts paid for an accident and health plans (sec. 105 (b), (c), and (d));

(3) the exclusion from income of amounts paid by an employer to an accident and health plan (sec. 106);

(4) the exclusion of the cost of up to $50,000 of group-term life insurance on an employee's life (sec. 79); and

(5) the exclusion from income of meals or lodging furnished for the convenience of the employer (sec. 119).

Explanation of Provision (sec. 1372(c))

Under the bill, the treatment of fringe benefits of any person owning more than two percent of the stock of the corporation would be treated in the same manner as a partner in a partnership. Thus, for example, amounts paid for the medical care of a shareholder-employee would be deductible by that individual only to the extent personal medical expenses would be allowed as an itemized deduction under section 213.

3. Treatment of oil and gas production

Present Law

Under present law, the allowance for depletion (including depletion with respect to oil and gas wells) for a subchaper S corporation is computed by the corporation and taken into account in determining the taxable income of the subchapter S corporation. The depletion deductions taken into account in determining earnings and profits of a subchapter S corporation are computed based on cost depletion. Thus, when a subchapter S corporation claims percentage depletion, it may generate current earnings and profits in excess of taxable income, and amounts distributed in excess of taxable income may be taxed as a dividend to the shareholders.

The right to claim percentage depletion with respect to oil and gas wells is limited under present law to certain independent producers and royalty owners. To prevent a proliferation of interests eligible for percentage depletion, present law provides anti-transfer rules which limit the ability of transferees to claim percentage depletion on production attributable to an interest in proven oil or gas properties transferred after 1974.

Generally, a transfer from an individual to a subchapter S corporation will result in the loss of percentage depletion unless the special rules provided in section 613A(c)(10) are satisfied. In essence, these rules require that the corporation's stock be issued solely in exchange for oil and gas properties and that there be an allocation of the barrel-per-day limitation on percentage depletion between the corporation and the individuals contributing the property. Similarly, the transfer of an oil and gas property from the subchapter S corporation to one or more of the shareholders would result in the loss of percentage depletion for production from the transferred property. However, the subchapter S election by a regular corporation is not treated as a transfer (Rev. Rul. 80–43, 1980–1 C.B. 133).

Under present law, the windfall profit tax is imposed upon the producer of domestic crude oil. In the case of a subchapter S corporation, the producer of crude oil is the corporation and not the individual shareholders. The transfer of property from or to a corporation would be a transfer resulting in the loss of lower rates on production by independent producers, unless one of the specified exceptions to the anti-transfer rules applied.

Explanation of Provision (sec. 3 (a) and (b) of the bill)

Under the bill, the allowance for depletion in the case of oil and gas properties held by a subchapter S corporation would be computed in a manner similar to that used in the computation of depletion in the case of partnerships. Specifically, the percentage or cost depletion allowance would be available directly to the shareholders of the subchapter S corporation and would be computed separately by each individual shareholder. Each shareholder would be treated as having produced his or her pro rata share of the production of the subchapter S corporation and each shareholder would be allocated his or her respective share of the adjusted basis of the subchapter S corporation in each oil or gas property held by the corporation.

For purposes of applying the anti-transfer rules in the percentage depletion provisions, the subchapter S corporation would be treated as a partnership and the shareholders would be treated as partners, Similarly, an election by a regular corporation to become a subchapter S corporation would be treated as a transfer of all the property of the corporation effective on the day on which the election takes effect. Finally, for purposes of the anti-transfer rules, the termination of a subchapter S election and the reversion to regular status would be treated as a transfer by the shareholders of all the assets of the subchapter S corporation to the regular corporation.

For purposes of the windfall profit tax, a subchapter S corporation would be treated as a partnership. Specifically, any subchapter S corporation which would otherwise be treated as a producer of crude oil would not be so treated; instead, all the crude oil produced by that corporation would be allocated among the shareholders in proportion to each shareholder's pro rata share of the income of the corporation. Each shareholder entitled to an allocation of crude oil would be treated as the producer of that crude oil for purposes of the windfall profit tax. Thus, for purposes of the independent producer lower rates (including the anti-transfer rules), the subchapter S corporation would be treated as a partnership and the shareholders of the subchapter S corporation would be treated as partners of the partnership.

4. Treatment of expenses owed to shareholders

Present Law

Under present law, a subchapter S corporation, in order to obtain a deduction for business expenses or interest payable to a cash-basis shareholder owning (after application of the constructive ownership rules of sec. 267(c)) more than 50 percent of the stock of the corporation, must actually pay such items not later than 2½ months after the close of its taxable year. If the shareholder owns 50 percent or less of the stock, a subchapter S corporation on the accrual method of accounting may accrue the deduction (to the extent otherwise allowable) notwithstanding that the shareholder does not include the amount in income until actually paid.

Explanation of Provision (sec. 3(g) of the bill)

The bill would place a subchapter S corporation on the cash method of accounting for purposes of deducting those expenses and interest owed to a cash-basis shareholder who owns at least two percent of the stock in the corporation. Thus, the timing of the corporation's deductions (which are taken into account on the shareholder's returns) and the shareholder's income would match. Also, no deductions would be lost if payment is made after the 2½-month period expires.

G. Tax Administration Provisions

Present Law

Under present law, a taxpayer's individual tax liability is determined in proceedings between the Internal Revenue Service and the individual whose tax liability is in dispute. Thus, any issues involving the income or deductions of a subchapter S corporation are determined separately in administrative or judicial proceedings involving the individual shareholder whose tax liability is affected. Statutes of limitations apply at the individual level, based on the returns filed by the individual. The filing by the corporation of its return does not affect the statute of limitations applicable to the shareholders.

Explanation of Provision (sec. 1375)

Under the bill, the tax treatment of items of subchapter S income, loss, deductions, and credits generally would be determined at the corporate level. Shareholders would be given notice of any administrative or judicial proceeding at which such items would be determined. Further, each shareholder would be given the opportunity to participate in these proceedings. Shareholders would be required to file returns consistent with the corporate return or notify the Internal Revenue Service of the inconsistency.

(Similar provisions were made applicable to partnerships by the Tax Equity and Fiscal Responsibility Act of 1982.)

H. Effective Date and Transitional Rules (sec. 1379)

The bill would apply to taxable years beginning after December 31, 1982. Existing subchapter S corporations would be treated under the new rules for the first taxable year beginning after that date. Tax-free distributions of undistributed taxable income from the last pre-enactment year could be made. Also, previously taxed income could be distributed during the first post-enactment year and the 2½-month period after the close of that year. Carryforwards, such as capital loss carryforwards and charitable contribution carryovers from the corporation's last pre-enactment year, would be treated as sustained in the first post-enactment year.

IV. OTHER CONGRESSIONAL ACTION

H.R. 6055, which is identical to S. 2350, was introduced on April 1, 1982, in the House of Representatives by Chairman Rostenkowski and Mr. Conable.

That bill was reported, with amendments, by the Subcommittee on Select Revenue Measures to the Committee on Ways and Means on July 15, 1982. The following amendments were made by the subcommittee.

Passive income test

The passive income test (which the bill retains for corporations with accumulated earnings and profits) would be modified, under the subcommittee amendments, by excepting interest on deferred payment sales of inventory; etc., and income from the conduct of a lending or finance business (as defined in sec. 542(c)(6)), from the definition of passive investment income. Also, only the net gain from the sale or exchange of capital assets (other than stock or securities) would be treated as the gross receipts from the disposition of those assets.

Second class of stock

The bill as amended by the subcommittee would provide that a corporation's subchapter S election would not be terminated because the corporation has outstanding any straight-debt instrument which is held by a person who is eligible to hold subchapter S stock.

Straight-debt would generally mean a written unconditional promise to pay on demand or on a specified date a sum certain in money, so long as the interest rate is fixed and the instrument is not convertible into stock. The determination of whether an instrument which does not meet these safe-harbor requirements is a second class of stock would be made under generally applicable tax principles regarding classification. The Treasury could prescribe regulations to coordinate the treatment of any safe-harbor instrument which otherwise is treated as equity with other provisions of the Code.

Foreign income test

The foreign income test would be repealed by the subcommittee amendments.

"Grandfather" provisions

Foreign or DISC subsidiary rule

A corporation with a foreign subsidiary or a DISC subsidiary which on June 23, 1982, was a subchapter S corporation could remain a subchapter S corporation so long as its election does not terminate, and the majority of its stock is not transferred after 1982.

Previously taxed income

Present-law rules allowing previously taxed income to be distributed tax-free would continue indefinitely under the subcommittee amendments, for income earned under the current subchapter S provisions.

Casualty insurance company

The amendments to subchapter S otherwise made by the bill would not apply under the subcommittee amendments, to a casualty insurance company described in section 831(a) if either—

(a) the corporation was a subchapter S casualty insurance company on July 12, 1982;

(b) the corporation was formed prior to April 1, 1982, and proposed, through a written private offering first circulated to investors prior to that date, to elect to be taxed as a subchapter S corporation and to be operated on an established insurance exchange; or

(c) the corporation is approved for membership on an established insurance exchange pursuant to a written agreement entered into before December 31, 1982, and the corporation is engaged in the casualty insurance business before the end of 1984.

The grandfather rule for these casualty insurance companies would continue until either the subchapter S election is terminated, or more than one-half the stock ceases (other than by reason of death) to be held by persons holding the stock on December 31, 1984.

Miscellaneous technical provisions

The subcommittee amendments would modify the bill to provide that a shareholder's portion of the corporation's income or loss for the taxable year in which the shareholder dies would be included on the shareholder's final tax return.

Also, the subcommittee amendments would clarify the provision allowing a shareholder to take into account his or her share of the corporation's loss in the year the corporation's stock becomes worthless.

V. REVENUE EFFECT

The revenue effects of this bill with respect to both amounts and timing cannot be estimated with precision. However, the net effect of the bill probably would be a revenue loss of less than $10 million annually during the next several years.

The provisions affecting eligibility for subchapter S treatment are expected to reduce budget receipts by less than $5 million annually.

The provisions affecting election, revocation, and termination of subchapter S status are expected to have a negligible revenue effect.

The provisions dealing with treatment of income, deductions, and credits are expected to reduce budget receipts by a negligible amount.

The provisions dealing with treatment of corporate distributions are expected to reduce budget receipts by a negligible amount.

The provision affecting taxable year of corporations is expected to increase budget receipts by a small amount.

All other provisions are not expected to have any significant impact on budget receipts.

PREPARED STATEMENT OF SENATOR BOB DOLE, THE SUBCHAPTER S REVISION ACT OF 1982

SIMPLIFICATION: PAST, PRESENT, FUTURE

Today's hearing marks another important milestone in the ongoing efforts of the bar, the accounting profession, and the Treasury and the Congress to simplify the Internal Revenue Code. Some cynics may point to the first publication this year of the Internal Revenue Code in two volumes and ask whether we are moving forward or backward in our simplification efforts. While none of us believe that we are in the final stretch, the progress we have made is clear. Two years ago we enacted the Installment Sales Revision Act. There is a good likelihood that we will see this subchapter S bill, perhaps with modifications, enacted before the Congress adjourns.

Nor are we likely to stop our simplification effort here. Much remains to be done. For example, the staffs are working with the American Bar Association tax section on a proposal to simplify the taxation of alimony payments. That proposal will be studied by us by the staff in the coming months. Additionally, we are engaged in a preliminary review of corporate taxation, to eliminate abuses and unnecessary traps for the unwary. The American Bar Association has recommended a narrow redefinition of reorganizations and the American Law Institute a more comprehensive revision of subchapter C. In short, I don't think that we are likely to run out of areas in which simplification efforts to reduce litigation, uncertainty and abuse will be richly rewarded.

THE SUBCHAPTER S REVISION ACT: OVERVIEW

This morning our focus is more narrow. We have before us a bill to revise comprehensively the rules for subchapter S corporations. The bill Senator Long and I introduced in the Senate and Congressmen Rostenkowski and Conable introduced in the House will expand the type of corporations eligible to elect subchapter S status, will narrow the possibilities for calamitous inadvertent terminations of subchapter S status, and will simplify the operations of subchapter S corporations. But the bill not only aids the taxpayer; it also eliminates the opportunity to abuse subchapter S, whether through the election of artificial taxable years to defer income or some other device. Despite the extended study given to this area by the staff of the Joint Committee on Taxation, the Treasury and our staff, there remain several areas in which final decisions must be made, and I am pleased that our witnesses will address many of those issues.

SUBCHAPTER S ELIGIBILITY

The bill expands the opportunity for corporations to make a subchapter S election. The number of possible shareholders is increased from 25 to 35. New corporations, and corporations without earnings and profits, may elect subchapter S status without regard to passive income limits.

One limitation that S. 2350 does not repeal is the prohibition against receipt of more than 80 percent of a corporation's income from foreign sources. Although such a repeal had been originally recommended by the staff, our caution led us to retain that limitation. I believe that the need for such a limitation should be carefully examined. The House subcommittee on Select Revenue Measures dispensed with this limit when it marked up this bill last summer.

SUBCHAPTER S OPERATIONS

The operation of subchapter S corporations has proved to be full of pitfalls. This bill would simplify the operation of subchapter S corporations and prevent the lock-in of earnings, the permanent disallowance of deductions for operating losses, and the potential conversion of ordinary losses into capital losses, to name only some of the most celebrated problems. Under this bill, subchapter S corporations really would be taxed like partnerships.

MAJOR ISSUES OUTSTANDING

Two major issues were identified by Senator Long and me in our introductory statements last spring. First, should any form of the passive income limitation be retained? Originally, the staff of the joint committee on taxation recommended total repeal: More recently, they have become persuaded of the possibility of abuse, and recommended that a passive income limitation be retained by corporations with accumulated earnings and profits. But how should passive income be defined, and should the limitation be 20 percent? I look forward to the testimony of our witnesses on this issue.

The second issue was whether a statutory definition of what constitutes a class of stock should be provided. Under subchapter S, only a single class of stock may be outstanding. If a nominal debt instrument is reclassified as stock for tax purposes, a corporation may find its subchapter S status terminated retroactively. Some urge that the section 385 regulations, if and when they ever become final, should provide the standard. I am sure that the Treasury staff knows what application of that standard would mean—although they may be the only ones here this morning who understand those regulations. Others urge that a corporation should be held to have two classes of stock outstanding only if it has, under the law of its state of incorporations, two classes of stock outstanding. And there are a host of intermediate positions. I look forward to the testimony of our witnesses on this issue as well.

The CHAIRMAN. I know that other members will be coming, along but I would like to start because we have a number of witnesses. We also would like to take care of some noncontroversial tariff matters. Finally, we have a matter on the Senate floor in which I am participating. I have asked the witnesses if they can be helpful and hit the high points in their written statements. Their entire written statements will be made part of the record.

I would just say as a matter of introduction to these hearings that in my view this hearing marks another milestone in the ongoing efforts of the bar, the accounting profession, and the Department of the Treasury to simplify the Internal Revenue Code. Some cynics may point to the first publication this year of the Internal Revenue Code in two volumes and ask whether we are moving forward or backward in our simplification efforts; I think that we are moving forward, and I do hope that we can proceed with subchapter S revisions.

Our focus this morning is narrow. We have before us a bill to revise comprehensively the rules for subchapter S corporations, which has been introduced by myself and Senator Long, and on the House side by Congressmen Rostenkowski and Conable.

There are some areas that we have not fully resolved, as I look back on the legislation, and myself and Senator Long identified these areas in our introductory statements last spring, such as whether any form of passive income limitation should be retained—and we are going to have some witnesses on that—and, second, whether a statutory definition of what constitutes a class of stock should be provided.

Therefore, we will be very pleased, first of all, to hear Dave Glickman, Deputy Assistant Secretary for Tax Legislation on behalf of the administration.

STATEMENT OF DAVID G. GLICKMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. GLICKMAN. Mr. Chairman, first let me say that I want to apologize. Our testimony is on its way up, our written testimony, and I will make my oral presentation very short and hope that my entire testimony will be in the record.

The CHAIRMAN. Yes, and I hope you will be able to remain a while in case any questions are raised.

Mr. GLICKMAN. Yes, sir.

I am pleased to appear before the committee today to express our views on S. 2350.

This bill, which is the Subchapter S Revision Act of 1982, as you said, was introduced by you and Senator Long in a culmination of the collegial process of the committees of both the House side and the Senate side, various bar groups and CPA groups. We think that the bill takes an area of the law which has included many traps for the unwary over the years and simplifies it, and makes the subchapter S much more analogous to the passthrough area and the partnership area under current tax rules.

We think that most of the changes in the bill are very, very worthwhile. In my testimony I have outlined a number of the changes that we think will be very helpful, will be simplifying changes, and will be changes which will remove many of the traps for the unwary. We will also have the entity-level audit which, as you know, Mr. Chairman, is very similar to the audit provisions recently enacted with respect to partnerships. From a compliance standpoint, we think this would be very, very beneficial also.

I would like to move directly to the issues in which you have asked for the principal discussion. There are two issues, the second class of stock issue, the debt equity issue, and what is commonly referred to as the C to S type of problem. The C to S problem is simply one in which a subchapter C corporation, a taxable corporation, elects to move into, to become a subchapter S corporation, a passthrough type of entity. There is no problem in this transaction under the new law, Mr. Chairman, if there are no earnings and profit at that corporate level. Either new corporations or existing corporations that have no earnings and profits can make that movement into subchapter S and obtain the benefit of all of the rules, the new rules, the new simplified rules, without any problem.

Now the only situation that the bill does not cover in that regard is the situation where you have a subchapter C corporation that goes to a subchapter S corporation and the C corporation has substantial earnings and profits. The problem here, Mr. Chairman, is one in which the income which had been at the corporate level in the subchapter C corporation has not been kept at the shareholder level. It really goes to the question of what is the nature of the transaction when you move from a subchapter C to a subchapter S. Since the subchapter S is more in the nature of a passive entity, more in the nature of a partnership, this really is tantamount to a liquidation of the corporation. In the purest tax parlance I think that what we would say the answer ought to be is that this ought to be a liquidation, it ought to be taxed as a liquidation, just as if the shareholders had liquidated and formed another entity, and the tax ramifications ought to flow accordingly.

Now, those tax ramifications are not nearly as significant if there are no earnings or profits. In fact, in many situations there would be no, could be no, might be no tax at the corporate or shareholder level but that simply is not the case when you have substantial accumulated earnings and profits at the corporate level.

Now, today I think you are going to hear a variety of alternative approaches to this "C to S" problem where there are accumulated earnings and profits. One will be what the bill looks like. Another one will be that we will just completely eliminate the passive investment income test across the board, even where there is substantial earnings and profits. Another approach which undoubtedly will be discussed will be one in which we set up a toll charge or a reduced liquidation type of tax, maybe a tax only on the earnings and profits at capital gains rates.

Each one of these, if you start on the assumption that we think the proper approach is the liquidation approach, each one of these leaves something to be desired. However, each one of them does add some simplicity to the law, a goal which I think you desire and which Treasury would desire also, as long as the potential for abuse is not overriding. We think that especially the toll tax type of approach has much interest to us. It does add some complexity to the law, which gives us some concern.

Our suggestion would be, Mr. Chairman, that with respect to this issue we enact the bill as it is right now, in other words, leaving the law just like it is with respect to those C corporations that move to S that have earnings and profits. Leave the passive investment income test in place. That will, obviously, not affect any corporation that is in an active conduct for trade or business now and wants to make the move because they can do that, and they would just be under the same law that they would be under now. The only type of corporation it could adversely affect in any manner would be those that want to go into principally a passive type of mode.

It would be our suggestion that before we cleanse that type of transaction where there is earnings and profit, that we have an opportunity to study that, and the Treasury Department, with your staff, would be very willing to do that in the future but if you think it is important enough to get the bill passed as it is, there is enough benefit and simplicity in the bill to get the bill as it is and then we can worry about this issue at a subsequent point in time.

Now, going to the next issue, which is the two classes of stock issue, in the bill right now, Mr. Chairman, there is a requirement that there can only be one class of stock in a subchapter S corporation. Obviously, the reason for that is it becomes very cumbersome to try to work out allocations between various classes of stock when you have a passthrough type of entity, and Treasury certainly supports the one class of stock classification.

The bill liberalizes that by saying that as long as it is common stock, even though one class is voting and one class is not voting, it doesn't make any difference any longer. The voting rights make no difference as long as it is one class of stock. The problem really arises more where you believe that there should be the two classes of stock requirement and then people start developing types of instruments which are masquerading as notes but really and truthfully are equity.

In that type of situation, Mr. Chairman, we have looked at this, the various alternatives. There are two possibilities: (1) The situation where you have straight debt; and (2) the situation where you have hybrid debt. In my testimony I have gone through the alternatives in some detail.

Really the critical issue here is, if it is a debt instrument, as long as it is under the debt equity rules—whether that is current law, 385, whatever rules we decide to adopt—as long as if it is debt, it is going to be debt for all purposes, only in the situations where some piece of paper which purports to be debt really turns out to be equity do we run into the problem. Even in that situation, if that piece of paper which is equity is straight—in other words, has normal debt provisions, in other words, fixed payment price, no conversion feature, fixed interest rates—we would generally think in that situation that the subchapter S election should not be terminated unless that debt is held by persons who cannot otherwise be shareholders in subchapter S corporations.

The only other type of situation that we would be concerned with is a situation in which there is special allocation—the interest rate is either high or low because of the fact that there is constructive ownership or family ownership between persons—in other words, you have a shareholder and his father is loaning the money to the corporation. That can present some tax avoidance purposes, also. We think the bill adequately addresses that issue the way it is: It targets it but it does not terminate the subchapter S election.

With the hybrid situation, that one gives us a great deal more trouble. We would recommend with the hybrid situation, Mr. Chairman, that if hybrid debt is issued and it is deemed to be equity, that will terminate the subchapter S election, will void the rules. The reason we really feel strongly about this is that one of the problems with the two classes of stock issue that has developed over the years is, again, the trap for the unwary. In our judgment the unwary do not issue hybrid-type instruments. The wary issue hybrid——

The **Chairman**. Unweary or unwary?

Mr. **Glickman**. Unwary. The hybrid-type instruments are issued by people who know exactly what the format is, and we think that a substantial gaming of the system can take place in the allocation area if you try to issue this kind of stock or this type of debt. We would recommend strongly that that type of situation could be deemed to violate the subchapter S rules and thus terminate the election.

Mr. Chairman, again, there are a number of other provisions which are covered in the testimony but I think that that is the conclusion of my statement and I will be happy to answer any questions you might have.

[The statement of Hon. David G. Glickman follows:]

For Release Upon Delivery
Expected at 10:00 A.M. EDT
September 10, 1982

STATEMENT OF
DAVID G. GLICKMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
BEFORE THE
COMMITTEE ON FINANCE
OF THE UNITED STATES SENATE

Mr. Chairman and Members of this Committee:

I am pleased to appear before you to express the views of the Treasury Department on S. 2350, the Subchapter S Revision Tax Act of 1982.

This bill, which has also been introduced in the House by Representatives Rostenkowski and Conable as H.R. 6055, reflects the comments of the staffs of the Senate Finance Committee, House Ways and Means Committee, Joint Committee on Taxation and the Treasury staff as well as the tax section of the American Bar Association, the Federal tax division of the American Institute of Certified Public Accountants and various other professional groups and individuals. We believe that this collegial process, with broad-based participation by Congressional and Treasury staffs and the private sector, is a fruitful way to develop technical tax legislation of this type. A similar process culminated in the Installment Sales Revision Act of 1980 and we are hopeful that we can be equally successful in the Subchapter S area.

Treasury generally supports the changes made by this Subchapter S bill. Subchapter S has been criticized as a complex set of provisions posing numerous "traps for the unwary" and we believe that the bill represents a substantial step toward simplifying and rationalizing the Subchapter S area. Of course, further technical improvements in the bill can undoubtedly be made. We hope that these potential improvements will be identified both through the hearing process and through additional efforts of our staffs. Also, the sponsors of the bill have requested further comment on several issues and we will address these issues later in our testimony.

Since the bill contains a large number of technical provisions, we will not discuss each one. However, we would like to set forth the most significant of the improvements made by the bill.

Partnership-like treatment. In several significant areas, the bill adopts rules for Subchapter S corporations which are similar to the current tax rules applicable to partnerships.

o Pass through treatment. Under current law, except for long-term capital gains, the character of income at the corporate level of a Subchapter S corporation is not passed through to its shareholders. Under the bill, the character of the corporate level items would pass through to shareholders in a manner analogous to partnership tax treatment. For example, capital gains and losses would pass through to shareholders as capital gains and losses. Section 1231 gains and losses would pass through without prior aggregation at the corporate level. Charitable contributions would pass through to the shareholders and would thus be subject to the individual's limits on deductibility. Tax exempt income would pass through as such and subsequent distribution of this income would generally not result in taxation. Foreign taxes paid by the corporation would pass through as such to the shareholders who would, subject to applicable limitations, claim them as credits or deductions. However, neither the Subchapter S corporation nor its shareholders would be eligible for the deemed-paid credit of section 902 for foreign taxes paid by foreign corporations in which the Subchapter S corporation owned stock.

- Partial elimination of earnings and profits. Under current law, a Subchapter S corporation maintains current and accumulated earnings and profits accounts in the same manner as a Subchapter C corporation. Distributions out of earnings and profits are taxed as dividends to shareholders except as special rules relating to distributions of "previously taxed income" and certain "undistributed taxable income" apply to prevent double taxation. The result is a complex statutory scheme, requiring careful attention to avoid inadvertent double taxation. Under the bill, Subchapter S corporations formed after the bill's effective date and other Subchapter S corporations without any accumulated earnings and profits would no longer have earnings and profits accounts so long as they remained Subchapter S corporations. This greatly simplifies the distribution rules for these Subchapter S corporations.

- Allocation of income on stock transfer. Under current law, a Subchapter S corporation's undistributed taxable income is includible in the income of the shareholders owning stock on the last day of the corporation's taxable year. This enables current shareholders to shift income to investors buying stock of a Subchapter S corporation late in the corporation's taxable year. Under the bill, the corporation's income would be prorated equally throughout the year and taxed to its shareholders on a daily basis (the way losses are currently allocated) unless the corporation closes its books on the date a shareholder terminates his interest in the corporation. This change provides a more realistic allocation of a Subchapter S corporation's income in a taxable year when there is a stock transfer.

- Loss carryover allowed. Under current law, a shareholder can deduct his pro rata share of a Subchapter S corporation's losses to the extent of his basis in the corporation's stock and debt. If the shareholder's allocable share of a corporation's loss exceeds the sum of these two basis amounts, the excess is not allowable as a carryover, even if sufficient basis is restored in a later year. Under the bill, such excess would be allowable as a carryover and could thus be deducted by the shareholder in the year sufficient basis is restored. This rule is analogous to the partnership tax rule.

Nonvoting common stock allowed. A Subchapter S corporation is permitted to have only one class of stock. Under the bill, a corporation would not be treated as having more than one class of stock solely by reason of differences in voting rights among the shares of common stock. Since differences in voting rights do not contravene the policies underlying the single class of stock requirement -- and since voting trusts are already permitted -- this is a sensible modification.

Partial elimination of passive income limitation. The bill eliminates the 20 percent passive income limitation for Subchapter S corporations with no accumulated earnings and profits. This eliminates a source of inadvertent terminations of Subchapter S elections -- and a source of wearying litigation -- for a significant class of Subchapter S corporations. The retention of the passive income limitation for corporations with accumulated earnings and profits will be discussed later in this statement.

Retroactive terminations eliminated. Under current law, a mid-year termination of a Subchapter S election is retroactive to the beginning of the taxable year. This enables shareholders of a Subchapter S corporation to decide after the fact whether it would be better to be taxable under Subchapter S or Subchapter C for the year, an unjustifiable opportunity for tax planning. The bill would eliminate this unwarranted opportunity by making a termination effective as of the date of the event causing the termination (thus splitting the taxable year into a short "S" year and a short "C" year).

IRS authority to waive inadvertent terminations. The bill gives the Internal Revenue Service the authority to waive an inadvertent termination of a Subchapter S election, subject to such adjustments as the Service may require. This would allow the Service to mitigate the sometimes unjustifiably harsh consequences of an inadvertent technical termination.

"Blackmail power" eliminated. Under current law, a new shareholder of an existing Subchapter S corporation can cause termination of the election by affirmatively refusing to consent, a power sometimes colorfully referred to as a "blackmail power." The bill would eliminate this "blackmail power" by making a new shareholder bound by a pre-existing Subchapter S election.

Limitation on fiscal year selection. Under current law, there are no limitations on the selection of a fiscal year by a Subchapter S corporation. This allows shareholders of a Subchapter S corporation to achieve substantial deferral of income by artful selection of the corporation's taxable year (e.g., an 11-month deferral for calendar year shareholders by selection of a January 31 fiscal year for the corporation). The bill eliminates this unwarranted planning opportunity by requiring a Subchapter S corporation to use a calendar taxable year unless it can demonstrate to the Service's statisfaction a business purpose for a different taxable year (subject to a generous "grandfather" rule for existing Subchapter S corporations).

Entity-level audit. Finally, the bill provides an entity-level audit provision for Subchapter S corporations. Under this provision, the tax treatment of items of Subchapter S income, loss, deductions and credits would generally be determined at the corporate level, with shareholders receiving notice and opportunity to participate in any administrative or judicial proceeding. These much-needed provisions are similar to the partnership level audit provisions recently passed by Congress as part of H.R. 4961 (the Tax Equity and Fiscal Responsibility Act of 1982).

As these changes illustrate, the bill makes many desirable changes in the Subchapter S provisions. It simplifies the Subchapter S area, eliminates "traps for the unwary" and curbs tax avoidance opportunities. We look forward to working with the committee staffs as technical issues emerge. One such technical issue deserves mention at this time. Under current law (and the bill), a Subchapter S election is terminated if the corporation derives more than 80 percent of its gross receipts for any taxable year from foreign sources. We see no reason to limit the international business transactions of Subchapter S corporations. Moreover, the current rules can lead to the inadvertent termination of an election and can sometimes be avoided through manipulation of the source rules. Thus, the Treasury Department believes that the foreign income limitation currently embodied in Subchapter S and retained in the present version of the bill should be eliminated.

There are two major areas in particular for which the sponsors of the bill have requested further consideration: the so-called "C to S" problem involving the election of Subchapter S by an active business corporation that has been operating under Subchapter C and has accumulated earnings and profits and the "second class of stock" problem involving the question of when purported debt should be considered a second class of stock, thus disqualifying a Subchapter S election.

The "C to S" Problem: Taxation of Accumulated Earnings and Profits

Under present law, when the shareholders of a corporation which has been operating under the Subchapter C regime elect to be taxed under Subchapter S, the election serves to lift the double tax (*i.e.*, the corporate income tax plus the dividend or capital gain tax on the shareholder upon distribution) from the future income of the corporation and to replace it with a single tax, at the individual shareholder's rates. In lifting the burden of the corporate tax from the future income of the corporation, the Subchapter S election resembles a liquidation of the corporation. As the Subchapter S provisions are changed to further resemble the partnership tax provisions (*e.g.*, by passing through to the shareholders the character of corporate-level items), the analogy between a Subchapter S election on the one hand and the liquidation of a Subchapter C corporation followed by the formation of a partnership by the former shareholders on the other hand becomes even stronger.

Although, in substance, a Subchapter S election and a liquidation are quite similar, their tax treatment is quite different. When a corporation is liquidated under section 331, there is a capital gains tax imposed on the shareholders, measured by the difference between the fair market value of the property they receive and their basis for their stock (a "stock basis capital gains tax").[1] In addition, there are various recapture taxes at the corporate level. Finally, the shareholders take a fair market value basis in the property distributed to them. However, when a corporation elects Subchapter S, there is no tax imposed and the corporation's basis for its assets is unchanged.

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[1] In certain situations described in the "collapsible corporation" provisions of section 341, this gain may be taxed at ordinary income rates.

To take the comparison a little further, suppose that the corporation has an active business and the shareholders wish to sell the business and invest the proceeds in marketable stocks and securities. If they liquidate the corporation under section 337, there will be no tax determined with reference to the corporation's basis in its assets on the sale of the business (except for recapture taxes) but there will be a stock basis capital gains tax imposed on the shareholders upon liquidation. If they elect Subchapter S and sell the business, there will be a capital gains tax imposed on the shareholders on the difference between the amount realized on the sale of the business and the corporation's basis in the assets being sold (an "asset basis capital gains tax") plus recapture taxes.[2] However, no stock basis capital gains tax will be imposed for the privilege of lifting the corporate income tax from the corporation's future income.

In analyzing the difference between the stock basis capital gains tax and the asset basis capital gains tax, it is instructive to focus upon the corporation's accumulated earnings and profits account. If the corporation has no accumulated earnings and profits, then the stock basis capital gains tax and the asset basis capital gains tax will be approximately the same. However, if the corporation has accumulated earnings and profits, then the asset basis capital gains tax will generally be lower than the stock basis capital gains tax, with the difference being generally attributable to the amount of the accumulated earnings and profits.[3] Another point which accentuates the importance of the accumulated earnings and profits account is that, if the corporation has no accumulated earnings and profits, the corporation can generally be liquidated tax-free under section 333. Thus, if the corporation has no accumulated earnings and profits, there is no great advantage (in terms of the liquidation analogy) to electing Subchapter S as opposed to liquidating the corporation.

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[2] We are assuming in our analysis that section 1378 of current law would not apply. In this connection we point out that it may be possible to avoid the impact of that section by having the corporation sell its active business on an installment basis.

[3] The difference may not be exactly attributable to the amount of the accumulated earnings and profits because of such factors as section 312(k) adjustments and intervening sales of stock.

If a corporation has accumulated earnings and profits, the Subchapter S election gives the corporation's shareholders a choice. If they merely wish to eliminate the corporate tax on the corporation's future income, they can use the Subchapter S election to accomplish this without the payment of any tax. If they wish to sell the corporation's business and invest the proceeds in passive investment assets the income from which would not be subject to tax at the corporate level, they can use the Subchapter S election to accomplish this with the payment by the shareholders of a asset basis capital gains tax rather than a stock basis capital gains tax. Since the stock basis capital gains tax would usually be higher than the asset basis capital gains tax, the Subchapter S route would usually result in a lower tax.[4]

The bill addresses this problem by forbidding a corporation from electing Subchapter S if it has accumulated earnings and profits and its passive receipts exceed 20 percent of its gross income. In effect, this would prevent a corporation from electing Subchapter S, selling off its active business assets, and using the proceeds to purchase passive investment assets. However, the bill would not prevent an active business corporation with accumulated earnings and profits from electing Suchapter S and thus lifting the burden of the corporate tax without the payment of a stock basis capital gains tax. In providing these results, the bill simply preserves current law on the question of when a corporation may use a Subchapter S election to lift the burden of the corporate tax without the payment of a stock basis capital gains tax.

The bill also provides that, for corporations with accumulated earnings and profits, distributions in excess of the corporation's "accumulated adjustment account" (essentially includible income minus deductible expenses which was not previously distributed) are considered to be out of accumulated earnings and profits and therefore are taxable as dividends. Also, when a Subchapter S corporation distributes appreciated property (other than in complete liquidation), the bill would require the distributing corporation to recognize the gain. Thus, although the bill does not require a tax to be paid on accumulated earnings and profits when Subchapter S is elected, the bill requires a dividend tax to be paid when a Subchapter S corporation extracts previously accumulated earnings and profits.

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[4] It is true that an actual liquidation results in a stepped up basis in the corporation's assets in the hands of the shareholders while the mere election of Subchapter S does not. However, if the stock of the Subchapter S corporation is held until the shareholder's death, the basis of the stock is stepped up under section 1014 and the corporation can then be liquidated without the payment of a stock basis capital gains tax to get the stepped-up asset basis.

The issue is thus what restrictions or costs should be imposed upon the election of Subchapter S by a corporation with accumulated earnings and profits.

There appear to be four alternatives: (i) the constructive liquidation approach (i.e., treating the election of Subchapter S as a liquidation of the electing corporation); (ii) the approach currently in the bill; (iii) the approach currently in the bill, modified by the complete elimination of the passive income restriction, and (iv) imposing some type of modified liquidation tax upon the election of Subchapter S.

We believe that the constructive liquidation approach comes closest of the four alternatives to achieving the correct theoretical results. This is the only alternative that would assure that the lifting of the corporate income tax from the corporation's future income will in all cases produce a shareholder tax on the full amount of the corporation's accumulated earnings and profits, and thereby eliminate the possibility that future income of the corporation that is attributable to accumulated earnings and profits of the corporation which never were (and may never be) taxed to the shareholder could be subject only to a single tax at the shareholder level. However, we note that the election of Subchapter S is not identical to a liquidation -- e.g., there is no stepped-up basis in the corporation's assets and the assets remain in corporate solution for state law purposes -- and we are mindful that, in many quarters, the imposition of a shareholder tax as a result of a constructive liquidation would be perceived as unacceptable.

We think the approach of the bill (which is generally the approach of current law) has both advantages and disadvantages. The principal advantage of the bill's approach is that it provides an incentive for corporations electing Subchapter S to pay out their accumulated earnings and profits to avoid the ever-present threat of disqualification under the passive income test. Thus, it provides an incentive for certain corporations to enter Subchapter S under the simplified no-earnings-and-profits regime. The other advantage of the bill's approach is that it maintains the present law barrier to the use of Subchapter S by Subchapter C corporations with accumulated earnings and profits which wish to sell off their businesses and invest in passive assets.

There are two principal disadvantages, however, to the bill's approach. First, the incentive to come within the simplified rules will not be strong enough to encourage companies with substantial accumulated earnings and profits to pay them out as dividends. Thus, both the accumulated earnings and profits account and the passive income test will be retained for a substantial class of Subchapter S corporations, bringing with it complexity and the possibility of inadvertent termination, both of which the bill elsewhere strives to eliminate. Second, there is no real conceptual difference between the case where Subchapter S is elected, the active business is sold off and the proceeds invested in passive assets and the case where Subchapter S is elected and the active business is retained. In both cases, the shareholders are achieving the principal benefit of a liquidation -- the lifting of the corporate tax -- and, therefore, the imposition of a liquidation-type tax would be appropriate. Nevertheless, by encouraging the payout of accumulated earnings and profits, the approach of the bill will to some degree promote the same results as would be achieved under a constructive liquidation.

The third alternative would be to adopt the approach contained in the bill coupled with the removal of the passive income restriction. The advantage of this approach is the elimination of what is, at best, a troublesome distinction that has historically produced complexity and inadvertent terminations. The major disadvantage is that this approach yields results that are the furthest removed, of all the alternatives considered, from the consequences of a constructive liquidation. That is, no corporation would need to make its shareholders recognize the gain attributable to its accumulated earnings and profits as a condition of lifting the corporate income tax.

The fourth alternative is the imposition of a modified liquidation tax. Although we view this alternative as a promising approach to this problem, there are many significant and very complex issues that must be resolved in fashioning such a tax. Some of the most important are:

(i) The amount subject to tax. Presumably, by reference to the liquidation model, the modified liquidation tax would be a capital gains tax upon the corporation's accumulated earnings and profits. In support of taxing only accumulated earnings and profits, it may be argued that a section 333 liquidation generally taxes only the accumulated earnings and profits (albeit at ordinary rates). Also, it may be argued that the tax on the corporation's unrealized appreciation in its assets (which is, in general, the other component of the shareholders' appreciation in his stock apart from the corporation's accumulated earnings and profits) is generally offset, for depreciable assets, by depreciation or cost recovery deductions which the shareholder may take with respect to the stepped-up basis of the assets in the shareholder's hands. On the other hand, it should be noted that for certain assets (land and good will, for example) there would be no such offset.

(ii) Period of time for paying the tax. Another issue is whether the modified liquidation tax should be payable over a period of time longer than one year. The argument in favor of the longer time period is that paying a large capital gains tax in one year might cause liquidity problems and, therefore, might be a deterrent to the election of Subchapter S. If there is a more-than-one-year period for payment of the tax, the appropriateness of an interest charge would have to be considered.

(iii) Anti-bailout provisions. There would, of course, have to be anti-bailout rules to prevent shareholders from shifting from Subchapter C to Subchapter S in order to bail out earnings at capital gain rates and then returning to Subchapter C.

(iv) Alternative to paying the modified liquidation tax. Another important issue is whether payment of the modified liquidation tax would be the only means by which a corporation with accumulated earnings and profits could elect Subchapter S or whether there would be an alternative, *e.g.*, being subject to current law rules such as the passive income limitation instead of paying the modified liquidation tax. Consideration must be given to such matters as the reliance interest of existing Subchapter S and C corporations; the complexity for the tax law of having two sets of Subchapter S rules; and the correctness under the liquidation model of allowing a Subchapter C corporation with accumulated earnings and profits to elect Subchapter S without any payment of tax. Consideration should also be given to the possibility, at least with respect to Subchapter C corporations, of "sunsetting" after a period of years the alternative to payment of the modified liquidation tax.

Although these are difficult issues, this approach reduces the tax burden of eliminating the accumulated earnings and profits account such that more corporations with accumulated earnings and profits will presumably incur the tax in order to come under the new simplied rules.

In light of our view that the constructive liquidation approach generally produces the proper results, we feel that none of the other alternatives are entirely satisfactory. Although the modified liquidation tax has promise, we think that the complexities of this approach have not been sufficiently explored to warrant adoption at this time. We believe that the current approach of the bill is preferable to the modification which eliminates the passive income restriction since this restriction promotes to some degree the results of the constructive liquidation approach favored by the Treasury. Thus, the Treasury Department endorses the bill in its present form and looks forward to working with your committee in the future in developing a more satisfactory solution to this problem.

The "Second Class of Stock" Problem: Application of Debt/Equity Principles

Under current law, a Subchapter S corporation may only have a single class of stock. In a number of cases, the Internal Revenue Service has argued that certain purported debt instruments should be treated as a second class of stock, thus invalidating a Subchapter S election. *See, e.g., Portage Plastics Co., Inc. v. U.S.*, 486 F.2d 632 (7th Cir.

(1973); James L. Stinnet, 54 T.C. 221 (1970). The Service has been unsuccessful in these attempts and, almost ten years ago, announced that it would not continue to litigate cases "factually similar" to those in which its "second class of stock" arguments had been rejected by the courts. See T.I.R. No. 1248 (July 27, 1973). Nevertheless, the question of when purported debt instruments will be treated by the Service as a "second class of stock," thus terminating a Subchapter S election, remains a source of uncertainty in the tax law.

The text of the bill does not address this question. It simply retains the single class of stock requirement without further elaboration. However, in their floor statement accompanying the introduction of the bill, Chairman Dole and Senator Long indicated that further consideration of this question is invited. Treasury would like to take this opportunity to analyze this issue in some detail.

The reason for the single class of stock requirement is that the existence of multiple classes of stock would make it too difficult to allocate a Subchapter S corporation's income and loss among the corporation's stockholders. Treasury believes that the rationale for this rule is sound and that the rule must be retained.

As a corollary of our belief that the single class of stock requirement must be retained, we believe it should not be possible for Subchapter S corporations to bypass the requirement by issuing instruments which are debt in form but which in substance are stock. Thus, it becomes necessary to examine purported debt of a Subchapter S corporation to determine whether it should be treated as debt for tax purposes or as a prohibited second class of stock.

In particular, there are two abuses posed by instruments issued by Subchapter S corporations that are debt in form but stock in substance. First, these instruments could be held by persons who would be ineligible to be shareholders of Subchapter S corporations (e.g., nonresident aliens or corporations). Thus, these instruments could be used to circumvent the limitations on who can be a Subchapter S corporation shareholder.

Second, these instruments could be used to achieve an allocation of income or loss for tax purposes which differs from the actual economic allocation of this income or loss. The purported debt holder might share the economic losses equally with the shareholder while the tax loss was passed through solely to the shareholder. This violates the general tax principle that tax losses should be deductible by the taxpayer suffering the economic loss.

> Example.
>
> Individuals A and B form a Subchapter S corporation. A invests $200 in exchange for all of the corporation's common stock and $100 of unsubordinated debt. B also invests $200, but in exchange for a $100 subordinated income bond and $100 of unsubordinated debt. Under the terms of the income bond, B is entitled to a $6 annual payment out of earnings and is entitled to share equally with A in the profits of the corporation after A has received a $6 dividend on the common stock. In its first year of operation, the Subchapter S corporation incurs a loss of $200. As an economic matter, the loss will be borne half by A and half by B. However, for tax purposes, the Subchapter S provisions would pass the entire loss through to A because B is not a "shareholder."

In order to prevent distortions of this type, it becomes necessary to scrutinize whether purported debt instruments such as the subordinated income bond in the example should be treated as debt or stock for tax purposes.

Having set forth our general concerns in the "second class of stock" area, we now turn to a more specific discussion of what we believe to be a sensible approach to reclassifying various types of straight and hybrid debt instruments as a second class of stock, thus disqualifying a Subchapter S election.[5]

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[5] For purposes of this discussion, we have assumed that hybrid instruments are instruments which are convertible into stock or which provide for contingent payments to the holder (*e.g.*, an income bond) and straight debt instruments are debt instruments other than hybrid instruments. Also, for purposes of this discussion, instruments are considered to be issued proportionately if holdings of the instruments and the issuing corporation's stock are proportionate. Thus, for example, if a Subchapter S corporation issued $25,000 of debt to each of its two 50-percent shareholders, the debt would be considered to be issued proportionately.

The issue is when purported debt which is treated as equity for tax purposes under applicable debt-equity rules (either the case law or the section 385 regulations) should be treated as a second class of stock, thus disqualifying a Subchapter S election. In general, we believe that straight debt instruments which are equity under applicable debt-equity rules should never be reclassified as a second class of stock so as to disqualify a Subchapter S election. The bill provides certain carefully-tailored rules -- and certain additional rules will be necessary -- to prevent the use of such debt to achieve unwarranted tax advantages. For hybrid debt instruments (i.e., debt convertible into stock and debt providing for contingent payments), we believe that the possibility of reclassification of such instruments as a prohibited second class of stock is necessary to prevent tax avoidance. A more detailed discussion of these conclusions follows.

Straight Debt Instruments

(a) Purported straight debt instruments not issued proportionately. When straight debt instruments are not issued proportionately, then under both the existing case law and the proposed regulations under section 385, the instruments are generally treated as debt for tax purposes. Treasury believes this is the correct result in the Subchapter S context as well.

(b) Straight debt instruments issued proportionately. Straight debt instruments issued proportionately pose more difficult questions. For purposes of discussion, it is useful to distinguish between "pure" proportionality and "constructive" proportionality. In the case of pure proportionality, the same person owns the stock and debt. Two examples of this are the sole shareolder who also owns 100 percent of the debt and the two 50-percent shareholders who each own 50 percent of the debt. In a case of constructive proportionality, the holders of the stock and debt are different persons who, because of their relationship, might not act in an arm's-length manner with respect to one another. An example of constructive proportionality would be where an individual was the sole shareholder of a corporation and the individual's father was the owner of all of the corporation's debt. We do not believe that pure and constructive proportionality are sufficiently well defined to form the basis of a statutory distinction; however, we see them as useful concepts for elucidating our policy concerns.

(i) Straight debt instruments issued with pure proportionality. When straight debt instruments are issued with pure proportionality, the concerns about having a second class of stock masquerading as debt are not present. First, there is no problem with the allocation of income and loss to the shareholders. Because of the existence of pure proportionality, the allocations that would result if the purported debt were treated as stock are no different from the allocations that would result if the purported debt were respected as debt.6/ Thus, the policy of avoiding complex allocations of income and loss among different classes of stock does not require the reclassification of pure proportionate debt as a second class of stock.

Second, since the holders of the purported debt are already shareholders, these persons must be eligible to be shareholders in a Subchapter S corporation (*e.g.*, not nonresident aliens or corporations). Thus, the policy of preventing circumvention of the limitations on eligible shareholders does not require the reclassification of pure proportionate debt as a second class of stock.

Therefore, in the case of pure proportionate straight debt, Treasury believes that such debt should not be reclassified as a second class of stock so as to terminate a Subchapter S election.

(ii) Straight debt issued with constructive proportionality. In the case of straight debt issued with constructive proportionality, the policy concerns relating to a second class of stock do apply.

First, there is a problem in that the holder of the purported debt may be a person not eligible to be a Subchapter S corporation shareholder. For example, a Subchapter S corporation might issue all of its stock to an individual for a nominal investment and a large amount of straight debt to a corporation wholly owned by the individual or to a nonresident alien relative of the individual. In this case, the debt is being used to circumvent the limitations on permissible Subchapter S corporation shareholders. A solution to this problem might be to require that, in cases of constructive proportionality, the holder of the debt must be a person who would be eligible to own stock in a Subchapter S corporation.

6/There may be timing differences and differences arising from the conversion of operating income into interest income. However, these can be dealt with more directly, as discussed below.

Second, there are potential problems of income allocation when there is constructive proportionality. Consider, for example, the case where an individual owns all of the stock of a Subchapter S corporation and his father owns all of the debt. By setting a very high or very low interest rate on the debt, the parties can allocate the income between father and son and, because of their relationship, the motivation for such allocation may be tax avoidance. Under the bill, current section 1375(c) is expanded to empower the Internal Revenue Service to make appropriate adjustments when an individual who is a member of the family of a Subchapter S corporation shareholder furnishes capital to the corporation without receiving reasonable compensation therefor. Treasury regards this provision as an appropriate means to prevent this type of tax-motivated income allocation.

In sum, Treasury feels that the problems posed by straight debt instruments held with constructive proportionality can be dealt with by carefully-tailored provisions aimed at specific abuses rather than by the more drastic method of reclassifying the instruments as a second class of stock. We think the bill deals adequately with the income allocation abuse described above and we think a tailored provision can be designed for the other abuse for which the bill does not presently provide a solution. We are continuing to study this area to determine whether further measures of this type would be necessary.

Hybrid Instruments

Hybrid instruments is the one area where we feel it is very important to retain the possibility of reclassifying a hybrid instrument as a second class of stock. Both of the policy concerns with equity masquerading as purported debt -- the problem of the ineligible shareholder holding the debt and the problem of income and loss allocation solely for tax effect -- are present for hybrid instruments.

As an example of the first problem, consider a Subchapter S corporation which issues a "debt" instrument for $100 to N, a nonresident alien. Under the terms of the instrument, N is entitled annually to 50 percent of the net profits of the corporation. A, a U.S. citizen buys the common stock for $100. It seems clear that N's "debt" instrument should be treated as stock and that the corporation should therefore be ineligible to elect Subchapter S.

An example of the second problem was set forth previously in the general discussion of the "second class of stock" issue. This example demonstrated how a subordinated income bond could be used to allocate all of the losses to the shareholder although, as an economic matter, half of the losses were borne by the bondholder.

In view of these potential abuses, we currently think it is important to preserve the possibility that a hybrid instrument may be reclassified for tax purposes as a second class of stock, thus disqualifying a Subchapter S election. The standard for determining whether a hybrid instrument would be reclassified as a second class of stock would be the current debt-equity case law or, when they go into effect, the rules applicable to hybrid instruments under the proposed section 385 regulations. There are two reasons why we currently favor this approach.

First, we believe that hybrid instruments are issued not by less sophisticated small businesses but, rather, by well-advised taxpayers who are familiar with the tax laws. Thus, the possibility of disqualification does not pose the proverbial "trap for the unwary."

Second, we believe that the danger of well-advised taxpayers using hybrid instruments issued by Subchapter S corporations as a means of tax avoidance is very real and the possibility of disqualification would serve as a deterrent to such use.

Thus, although we would certainly consider a more tailored approach, our present view is that the possibility of a hybrid instrument's being reclassified as a prohibited second class of stock should be preserved.

An additional tax avoidance use of excessive debt should be noted. With respect to both straight debt and hybrid instruments, shareholders could use excessive debt to convert operating income into interest income. For example, if a Subchapter S corporation issued only stock to its shareholders, then the shareholders would take into account a pro rata share of the corporation's operating income and deductions, with the character of the income and deductions passing through to the shareholders. If, however, the corporation issued to its shareholders a nominal amount of stock and large amounts of debt, then the net operating income might be offset by a large interest deduction and the shareholders would take into account a large interest payment instead of a share of operating income and deductions. This is an unwarranted planning opportunity which might be used, e.g., to generate investment income under section 163(d).

Treasury believes, however, that this potential abuse can be addressed with a tailored provision aimed at this particular problem, rather than by the more drastic remedy of reclassification as a prohibited second class of stock.

Finally, the bill makes it unnecessary to convert the purported debt into equity solely to eliminate potential timing benefits which might be achieved as a result of accruing interest that may not be paid. Suppose that A and B are each 50-percent shareholders of a Subchapter S corporation and that B lends money to the corporation. If interest on the loan is accrued but not paid and the corporation is an accrual basis taxpayer while B is a cash basis taxpayer, then the interest is deductible by the corporation (in effect, half by A and half by B) but not includible in B's income. Under current law, this transaction is beyond the reach of section 267, which is designed to prevent abuses of this sort. Under the bill, section 267 is amended to provide that, with respect to interest payments and expenses deductible under sections 162 or 212 paid to a cash basis taxpayer, payments between a Subchapter S corporation and certain related parties -- including a 2 percent direct or indirect shareholder of the Subchapter S corporation -- are not deductible to the payor before the day the payment is includible by the payee. Thus, in the above example, the interest would not be deductible by the Subchapter S corporation until it was actually paid to B. Treasury believes this provision will prevent this kind of timing abuse.

The foregoing discussion of the "second class of stock" issue is intended not as a blueprint for a new statutory scheme but, rather, as a discussion of the Treasury's view of the conceptual issues involved. We hope that it will serve as a springboard for continued consideration of this difficult issue.

Finally, in the interest of brevity, we have not attempted a technical discussion of the bill beyond the "C to S" and the "second class of stock" issues. For example, we have not addressed the appropriate treatment of warrants in the second class of stock context, and the proper treatment of purported debt which is treated as equity under Subchapter C but is deemed not to violate the Subchapter S second class of stock requirement. To the extent practical, we will continue working with the Committee to resolve these and other technical issues that may arise.

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I would be pleased to answer any questions you may have.

The CHAIRMAN. Now as I understand, your statement will be available to——

Mr. GLICKMAN. It ought to be up here within 5 or 10 minutes.

The CHAIRMAN. I am going to yield to Senator Long, who may have a question.

I know this is a very technical area. I guess I do not understand it all, but hopefully I may. We do want to try to act on this bill this year. We think it is important. We understand the House will be moving or will try to move this week in the full committee, and that they may even have the bill over here by the 20th of this month, so we will be working with Treasury and with the bar and the accountants and others who have a direct interest in, as I have indicated, simplification, plus there are some who have special concerns and we hope to be able to accommodate most of those.

If you can stick around a while, it would be helpful.

Senator Long?

Senator LONG. Mr. Chairman, I want to commend you for holding these hearings and I also want to commend you for introducing this bill. As you know, I am a cosponsor of the bill, and if there is one thing that the public approves of and one thing that there should not be any argument about, it is tax simplification. Everybody agrees that the laws are too complicated, too cumbersome. There are too many pitfalls in the law that need not be there, and they ought to be eliminated.

Now the House left the burden on this committee to initiate the big bill to raise taxes. We didn't claim that credit but we didn't have much choice about it, and you provided the leadership to do all that. This, then, should be a popular bill. There shouldn't be anybody against it and so it ought to be initiated in the House and I would hope very much that the House would either send us this or something similar so that we would have a proper vehicle to act on. I want to assure you that I will give you the best support I know how to give you in the passage of this measure.

I have a more complete statement I would like to put in the record at this point.

The CHAIRMAN. Do you have any questions?

Senator LONG. I have no questions of the witness.

[The prepared statement of Senator Long follows:]

STATEMENT OF SENATOR RUSSELL B. LONG
Finance Committee Hearing on the Subchapter S Revision Act of 1982
September 10, 1982

Mr. Chairman, I would like to commend you for holding these hearings to consider S. 2350, the Subchapter S Revision Act of 1982.

I am a cosponsor of this bill, together with the Chairman. I believe that this legislation is important, first, because it represents a continuation of the Finance Committee's efforts to simplify and improve the tax laws and, second, because it provides a real benefit to small business.

Early in the last Congress, Senator Dole and I announced a program to simplify and improve the operation of the Internal Revenue Code through a series of bills examining particular problem areas.

Under this program, the professional staff of the Committee would work together with the professional tax staffs of the Joint Committee on Taxation, the House Ways and Means Committee and the Treasury to identify areas in the tax laws that were in need of technical improvement. These tax staffs working in the Government would consult with tax professionals and affected taxpayers outside the Government in an effort to develop more workable approaches to these particular problem areas.

The first bill under this program was enacted in 1979 as Public Law 96-167. This bill simplified certain aspects of the procedural provisions of the Code.

The next bill was the Installment Sales Revision Act of 1980, which completely revised and improved the tax treatment of an entire area of commercial transactions.

The Subchapter S Revision Act is another thorough revision of an important area of the Code. Subchapter S removes the corporate level tax and permits shareholders to report the corporation's income and losses directly on their own returns. Because Subchapter S is used extensively by small businesses, it should operate in a relatively simple fashion and should not contain tax traps for unwary taxpayers. Unfortunately, the current version of Subchapter S does not always operate in a straightforward fashion and, as a result, many taxpayers have suffered adverse tax consequences from innocent technical mistakes.

In 1981, Congress lowered the top individual tax rate from 70 percent to 50 percent, so that the top individual and corporate tax rates are now fairly close together, at 50 percent and 46 percent respectively. In addition, the 1981 Tax Act permitted certain trusts to own Subchapter S stock. These two changes have substantially increased the attractiveness of operating a business through a Subchapter S corporation. This is all the more reason to enact legislation that will make Subchapter S easier for business people to work with.

The tax simplification process works best when the public participates actively and shares with the Congress its views on how proposed legislation can be improved. I am pleased that this bill is being handled through the regular process, with full opportunity for affected taxpayers to study the bill and to voice their approval, disapproval or suggestions for change. I would also like to express my appreciation to the witnesses for taking the time and effort to participate in this hearing today, and to the many lawyers and accountants who have taken time out from their private practices to work with the Committee staff over the past months and years in seeking to improve this legislation.

Mr. Chairman, I hope that the House of Representatives will pass the Subchapter S Revision Act and send it to the Senate for its consideration during this session of Congress. In that event, I would hope that the Finance Committee would report the bill favorably, with such improvements as may be appropriate, based on these hearings and on such other comments and suggestions as we may receive. The passage of this legislation would be an important step towards tax simplification for small business, and I hope that we can achieve passage before this Congress adjourns.

The **CHAIRMAN**. Thank you.

Senator Grassley?

Senator **GRASSLEY**. Mr. Chairman, I have a statement, too, that I want to put in the record.

[The prepared statement of Senator Grassley follows:]

Charles Grassley

Mr. Chairman. I am thankful that the committee is examining this issue in greater detail. As a representative of a state with a great number of Subchapter S taxpayers, this legislation is very important to many of my constitutents.

In my view, the new eligibility requirements are much more realistic. Permitting the number of shareholders to be increased from 25 to 35 people is a sensible move which more accurately reflects modern business organization. Eliminating the one-class-of-stock and the passive investment restrictions on corporations without earnings and profits is an important reform which should eliminate some of the hardship these corporations face when their profit picture changes. Denying a shareholder the right to have the Subchapter S election revoked, even though that individual became a shareholder after the inital election, should prevent minority tyranny which is peculiar to this type of organization.

Extending the time during which an individual can elect to become a Subchapter S corporation or elect out of Subchapter S is an important reform. Many small businesses are uncertain of their anticipated earnings on the last day of the first month of their taxable year. Extending the time during which an election must be made to the fifteenth day of the third month of the calendar year will enable many small businesses to better plan their tax matters.

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Another important provision of this bill permits losses to be carried forward to the extent the losses exceed the shareholder's basis in stock and loans to the corporations. This eliminates another senseless restriction on Subchapter S shareholders who are often struggling to make ends meet.

This bill is an important milestone in creating parity between Subchapter S organizations with other forms of corporate organizations. The comments of the witnesses will be helpful to all of us in deciding if further refinements to this legislation are necessary. They should help us to perfect this legislation and end this needless discrimination permanently.

Senator GRASSLEY. The only question I have in addition to my statement—concerns the Tax Equity and Fiscal Responsibility Act, which would change the pension provisions as they relate to subchapter S corporations. The effective date in the recent tax bill is different from what is in this bill, so which effective date are we going to use? Which effective date would you suggest we use?

Mr. GLICKMAN. Well, I think this is something that we ought to be talking to the staffs about and try to make a decision about that. I guess our reaction right now is that in view of the fact that in the larger bill we did obtain parity, in essence, what we hate to see is to set out a set of rules now where all these corporations are forced to change their plans on January 1 of 1983 and then again are forced to change their plans on January 1 of 1984.

Therefore, our suggestion might be that we leave the pension rules in place, as they are right now in the law, until the new rules come into place and then it will become a moot point, it seems to us, but this is something that we are still studying right now ourselves. We do not want to force these plans to amend more than once, is what we really want to avoid.

Senator GRASSLEY. Then, that would more or less dictate taking the later date.

Mr. GLICKMAN. What it would do is, it would leave—that's right—it would leave, it would not make any changes. It would perhaps eliminate the changes that are in the bill right now with respect to the pension provisions, leave the present rules in place right now until January 1, 1984, and then everyone will be on the same ground starting on January 1, 1984.

Senator GRASSLEY. Well, then, doesn't that mean that we will have to change the date in the tax bill we just passed?

Mr. GLICKMAN. No, sir.

Senator GRASSLEY. We don't?

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Mr. **Glickman**. No, sir. What we would do is, we would leave that date in place. We have some pension provisions in this bill. We would not make any changes in this bill in the pension provisions. We would just leave the law as it is, and then on January 1, 1984, I think that everything would come out correctly at that point.

Senator **Grassley**. Another question—I'm sorry: Do you have any objection to subchapter S corporations being audited and bound at the corporate level rather than at the shareholder level?

Mr. **Glickman**. No, sir. Before you came in, this was one of the issues that we mentioned. This bill does in essence adopt the same approach that was in the larger bill on the entity-level audit rules.

The **Chairman**. Senator Armstrong?

Senator **Armstrong**. Mr. Chairman, I thought the session was ending so, thank you, I will have some questions later.

The **Chairman**. Mr. Glickman is going to remain.

Senator Symms, do you have any questions?

Senator **Symms**. Mr. Chairman, I have a statement that I would like to put in the record and a memorandum that is attached to it, and have unanimous consent to just save time by permitting me to put this in. I compliment you and Senator Long for bringing this to the committee and for the work that you have done. I know that there are some things that need to be done in this area of the eligibility rules on the subchapter S corporations, and I will ask unanimous consent just to submit my statement to the record.

The **Chairman**. Your statement will be made a part of the record.

[The prepared statement of Senator Symms follows:]

SENATOR STEVE SYMMS

SENATE COMMITTEE ON FINANCE

SEPTEMBER 10, 1982

Good morning. I am pleased that this Committee is at last attempting to correct the inequities currently existing in Subchapter S. I would like to commend Senator Dole and Senator Long for their efforts in this area.

Generally, I believe that we are considering today, S. 2350, is well-thought out and well-drafted legislation, and it could have a broad beneficial effect on small businesses by eliminating certain traps and easing eligibility rules. In passing, however, I would like to point out, however, that the bill could be further improved if restrictions on retirement plans and fringe benefits, two classes of stock and permissible stockholders were eased.

Presently, the bill preserves, in a limited but very troublesome way, one of the greatest traps of current law. This is the passive income test. I do not disagree with the Department of the Treasury's statement that this test is a "source of inadvertant terminations of Subchapter S elections -- and a source of wearying litigation -- for a significant class of Subchapter S corporations. As the Joint Committee staff stated in 1980, "elimination of this restriction would remove much uncertainty, reduce litigation, and prevent retroactive terminations of Subchapter S elections."

While the bill would eliminate the passive income test for new corporations and those without any earnings or profits, it would retain the passive income test for all electing corporations with accumulated earnings and profits. This includes many corporations which have already elected Subchapter S and many of which who want to elect in the future.

Retention of the passive income test for companies with earnings and profits presents a very real problem. Many corporations will be subject to the trap but won't know it. The computation of tax earnings and profits is very difficult for even the most sophisticated, and many small corporations believe incorrectly that if they have no earned surplus, they have no earnings and profits. The problem will be compounded by new Section 312(k) which requires a much different computation of capital cost allowances for earnings and profits purposes than that permitted for tax computation purposes.

Two arguments have been presented, thus far, to support retention of the passive income test. Neither, I believe, stands examination because a) Some argue that without it accumulated earnings could be enjoyed or siphoned out after election without shareholder tax. This is not so; under the bill the shareholders of Subchapter S corporations would continue to be taxed on dividends out of accumulated earnings. The Subchapter S election is in no way equivalent to a taxable liquidation; basis and earnings and profits carry over, and withdrawal of accumulated earnings and profits produces the same tax consequences as if no election has been made. b) Other argue that since Congress restored stepped-up basis at death, an election under Subchapter S by a regular corporation with accumulated earnings means that heirs of deceased shareholders could somehow avoid tax. This is simply an argument against stepped-up basis at death.

In short, the passive income test should be removed completely.

The CHAIRMAN. Could we then move on the first panel of witnesses?

Senator ARMSTRONG. Could I ask just one question, Mr. Chairman. I am referring to page 7 of the committee print, and it has to do with the question of accumulated earnings and profits of subchapter S corporations which have passive investment income. In the middle of the page under the topic heading 5, source of income, the second paragraph, it says: The bill would generally repeal the requirement that a subchapter S corporation may not have more than 20 percent of its gross income in the form of passive investment income. However, that requirement would continue to apply to the corporations which have, at the close of the taxable year, accumulated earnings and profits from years prior to electing the new subchapter S provisions.

I think I understand what that means but could you elaborate just a bit on that? My question really is this: If a corporation, say, comes into existence after the effective date of this act, it may nonetheless accumulate earnings. You are saying no.

Mr. GLICKMAN. After the effective date of the act, a subchapter S corporation will not have any accumulated earnings and profits from that point forward. The bill will provide that also. What you just now read, Senator Armstrong, was a situation in which you have a subchapter C corporation or possibly a subchapter S that was in existence before the effective date of the act, had accumulated earnings and profits and then elected to become a subchapter S corporation. In that situation the passive investment income test will remain in place but from the effective date of this act forward, any new corporation formed or any old corporation that elects subchapter S that had no accumulated or current earnings and profits as of the date that it became a subchapter S corporation, will not be subject to the passive investment income rules and will not have any earnings and profits from that point forward.

Senator ARMSTRONG. However, no subchapter S corporation formed after the date of this act may accumulate———

Mr. GLICKMAN. No. There will not be an earnings and profits concept. In other words, all the problems that were engendered———

Senator ARMSTRONG. That is just washed out altogether?

Mr. GLICKMAN. That's right.

Senator ARMSTRONG. I see. Well, let me just ask one additional question, then: When we say the close of the taxable year, are we really talking about the last day of the taxable year or are we talking about some date 60 or 70 or 80 days after the taxable year?

Mr. GLICKMAN. No, no, no. The subchapter S election will be effective as of the first day of a taxable year of the corporation, so we are talking about the close of the prior year, the close of the prior year of that corporation, whenever that happens.

Senator ARMSTRONG. I do not think this is a policy issue but what is not clear to me is, How can a subchapter S corporation or any corporation know precisely on the last day of its fiscal year what its earnings are for that year? If there were a requirement that it pay out such earnings, say, within 75 days or 90 days or something, I could understand that, but how will they even know on the last day of the fiscal year what their operating performance has been?

Mr. Glickman. Well, there will be some flexibility as to when they can make the subchapter S election for the year in question by. In other words, they don't have to make the election as of that last——

Senator Armstrong. I am sorry, and I do not want to draw this out but this is an important point to a lot of people that have subchapter S corporations: If you make the election—let's say you are a subchapter S corporation—as I understand what you have told us, you forfeit that election if you do not pay out all of the earnings of the corporation. Is that——

Mr. Glickman. I am sorry. If you have earnings and profits as of the end of the year prior to the year you make the subchapter S election, you can still make the subchapter S election; there is no problem with that. The only thing that the law would then require is that you are still subject to the passive investment income test. In other words, no more than 20 percent of your gross receipts can be attributable to passive investment income, so that a going business that has big earnings and profits at the end, on December 31, 1982, can elect subchapter S in the year beginning January 1, 1983, and can have the benefit of all the rules, except that that corporation will still be subject to the passive investment income test.

Senator Armstrong. I see.

Mr. Glickman. Therefore, the only thing earnings and profits——

Senator Armstrong. What about a new corporation coming into existence?

Mr. Glickman. On January 1? A new corporation coming in on January 1 will not be subject to the earnings and profits rules, period. In other words, it will be free of any of the passive investment income——

Senator Armstrong. I see. OK. Thanks.

Thank you, Mr. Chairman.

The Chairman. I think we have a number of questions in that area. I do not know that there is any magic about 20 percent. Maybe it ought to be 50 percent. Maybe there ought to be some threshold on accumulated earnings. There are a number of questions that we probably will address as we hear other witnesses, and then at a staff level, working with Treasury and members of the bar and others who have a direct interest, we would hope that we could come up with some product that would have almost unanimous approval.

Thank you, Mr. Glickman.

Mr. Aidinoff, chairman of the American Bar Association Tax Section, and William T. Diss, chairman of the Small Business Taxation Subcommittee, American Institute of Certified Public Accountants.

Let me indicate to the witnesses that your entire statements will be made a part of the record, and you may proceed in any way you wish.

STATEMENT OF M. BERNARD AIDINOFF, CHAIRMAN, AMERICAN BAR ASSOCIATION TAX SECTION

Mr. AIDINOFF. Mr. Chairman and members of the Senate Finance Committee, my name is M. Bernard Aidinoff. I am chairman of the tax section of the American Bar Association. I will present the section's position on S. 2350.

As you are aware, the section on taxation has worked very closely with the staffs of the various congressional committees and with the Treasury Department and the AICPA on the development of this legislation. The section strongly supports the enactment of S. 2350 with some technical changes. S. 2350 makes subchapter S more workable. It eliminates a good deal of the restrictions and the complexities under existing law.

I have attached to my statement, which is part of the record, various technical comments, and I do not propose to discuss these technical comments. I would like to confine my oral testimony to the two areas on which this committee has indicated it wishes comments. The first area that I would like to discuss is the two classes of stock problem and the potential application of the section 385 regulations when they are promulgated or, for that matter, existing case law characterizing various forms of debt as equity to subchapter S.

We are convinced that the section 385 regulations as such, in whatever form ultimately promulgated, should not be controlling for purposes of subchapter S. For that matter, the automatic application of existing law characterizing particular types of debt as equity for Federal income tax purposes to subchapter S is inappropriate. The reason why we have a two classes of stock restriction is really to prevent misallocation of income, and we believe that in the case of most instruments characterized as debt, we really do not have an allocation problem at all.

With regard to straight debt, if it is issued proportionally there is no problem. If the straight debt is not issued proportionally, the only place where we believe that there may be a problem is in family relationships, and in that particular case normal audit techniques dealing with allocation of income can handle the problem of misallocation of income and therefore should not affect eligibility under subchapter S.

In addition, when we are talking about unrelated lenders who receive a note in exchange for cash, there really is no reason to question whether such debt is good debt for tax purposes because the bargaining between the parties will assure that there is appropriate income allocation. There should be no concern whatsoever in the case of straight debt instruments that are issued for cash, whether they are issued proportionally, to related parties or, for that matter, to corporations.

The only area where there may be a problem is in the case of hybrid securities. I wish we were in agreement with the Treasury Department in believing that it is only sophisticated subchapter S corporations that have hybrid debt. It is sophisticated lenders that require hybrid debt and sophisticated lenders may very often impose their wishes on unsophisticated subchapter S corporations.

We suggest that as a rule, that a hybrid security should be considered as debt for subchapter S purposes except in that situation where more than 50 percent of the value of the instrument is attributable to an equity income sharing provision. We think that would be a workable solution, would adequately protect the revenue, and the use of hybrid debt as a substitute for a second class of stock.

With respect to the C to S problem, one, we support the concept that if we have a corporation that has no accumulated earnings and profits, there should be no passive income limitation. With respect to corporations which have accumulated earnings and profits, we believe really there ought to be two choices: One, acceptance of a passive income limitation though not necessarily the one in the bill, on the other hand, if the corporation wants to continue in the future without being subject to a passive income limitation, it ought to be able to achieve that result by paying an appropriate toll charge. We believe that an appropriate toll charge would be a capital gains tax on the accumulated earnings and profits, or if lesser, the capital gains tax that would be payable on a liquidation of a corporation, and we would have that tax payable over a 5-year period.

If the corporation is willing to pay the toll charge, then it can have complete simplicity and not be subject to a passive income limitation. If it is unwilling, it will be subject to the rule. We do not believe that this adds any complexity to the law. The complexity with respect to the toll charge is there only with respect to the corporation that is willing to have its shareholders pay that toll charge. We believe it is an appropriate toll charge, and we really think that the time to face the question of whether this option should be available is now. We have worked a long time on these proposed revisions to subchapter S. The concept of an elective toll charge has been the subject of much discussion between the bar and others interested in subchapter S, and nobody need pay that toll charge if he does not want to. On the other hand, if there are problems with respect to computing passive income and what constitutes passive income, a corporation can achieve simplicity by, in effect, cleansing the past and then going forward without any limitation whatsoever.

Thank you.

The CHAIRMAN. Mr. Diss?

STATEMENT OF WILLIAM T. DISS, CHAIRMAN, SMALL BUSINESS TAXATION SUBCOMMITTEE, FEDERAL TAX DIVISION, THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. DISS. Mr. Chairman, my name is William T. Diss, chairman of the Small Business Taxation Subcommittee of the American Institute of CPA's. We have submitted written comments which largely follow and supplement comments submitted June 14 on H.R. 6055 to the House Select Revenue Measures Subcommittee.

We support the bill enthusiastically. The S. 2350 version represents the collegial efforts of the American Bar Association Tax Section, the American Institute of CPA's, the joint committee staff, and other interested parties. In addition to the bill as introduced, we support the changes that were made by the House subcommittee to H.R. 6055. In particular, we applaud the provision in S. 2350 which repeals the passive receipts limitation, the provision for carryover of unused loss allocations, and the repeal of the concept of current year earnings and profits. That last one, we believe, has caused many complications simply not identified in practice.

In addition to the amendments adopted by the House subcommittee, we recommend that you give favorable consideration to excluding rents from the list of passive investment income items—if the passive receipts test is not eliminated altogether. In regard to the deferral of deductions for rent, salaries, or interest that are owed to a 2-percent or larger stockholder, we recommend that you consider the guaranteed payment approach that is followed for partnerships, that is, to accelerate the reporting of the income by the cash method stockholder so that it falls in the same year as the deductions taken by the corporation. This would follow the same reporting pattern as rent, interest, salaries accrued by a partnership to a partner.

Furthermore, we recommend that the original consensus reflected in the April 1980 joint committee print be followed for fringe benefits, specifically that fringe benefits not be repealed except for corporations that do not satisfy the 20-percent passive receipts limitation. That was the compromise struck in the April 1980 version of the joint committee print and we recommend that you return to that consensus.

In the same connection, we recommend that the fiscal year conformity requirement be confined to investment companies and that companies which satisfy the 20-percent passive receipts limitation of current law be allowed to continue to adopt fiscal years other than the calendar year. We observe in this connection that in the case of a partnership or a fiduciary that a complete deferral of income is achieved with a fiscal year. That is not true for a subchapter S corporation except for undistributed taxable income.

Moving on to the two questions posed by the chairman for the hearing today, the first relates to debt instruments. We join the bar in recommending that the section 385 regulations as such have no application to electing subchapter S corporations. However, we acknowledge that in some cases a hybrid instrument that walks, talks, and looks like a stock should be reclassified as stock if it is held by a person who would otherwise be ineligible to be a subchapter S stockholder, for example, a hybrid instrument that would be issued to a foreign person, a permanent trust, or another corporation that itself would be an ineligible stockholder. We assume that variable interest and inflation provision notes would not be considered hybrid instruments for this purpose.

We would oppose any authority to reclassify debt where the intent is to shift a loss allocation. If one investor holds stock in a corporation and a second investor holds debt, the loss should be allocated to the investor who holds the stock and there should be no reallocation to debt. Local law and economic reality indicate that it is the stockholder who bears the loss first and then the creditor.

In regard to the accumulated earnings and profits upon an election of a subchapter C corporation, that is, the "C to S" problem, the American Institute believes that existing law is adequate. The comparison with a liquidation and a reincorporation as a personal holding company is not close at all. There are decisive differences. There is no basis step-up of assets inside a corporation upon a subchapter S election, as you find in a liquidation, and all of the assets of the corporation, including cash and the related earnings and profits still remain in corporate solution.

However, in order to maintain the consensus posture that the AICPA has followed with the American Bar Association tax section on the bill, we would support an elective toll charge if the corporation would otherwise be a personal holding company. This toll charge would take the form of a 5-year installment, long-term capital gains tax on the smaller of the net gain realized—hypothesized—or the accumulated earnings and profits.

I must admit that our support is reluctant because we believe this adds considerable complexity to the law, including the computation of the accumulated earnings and profits in itself, the need for antibailout restrictions, and the need for acceleration provisions if the corporation is liquidated within the 5-year installment period. It does not seem to be a suitable time to load on a large body of complication of the law but if the committee feels it is desirable to provide such a bailout toll charge, we would support the toll charge reluctantly.

We believe existing law is sufficient. If there are accumulated earnings and profits, they will be taxed to the shareholders under dividend sourcing rules when distributed. We are inclined to believe the "C to S" problem is somewhat overstated.

[The statements of Mr. Aidinoff and Mr. Diss follow:]

SUMMARY OF POINTS
M. BERNARD AIDINOFF, CHAIRMAN
SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

COMMITTEE ON FINANCE
UNITED STATES SENATE

September 10, 1982

S. 2350 --The Subchapter S Revision Act of 1982

1. The Section of Taxation of the American Bar Association has been actively involved with Congressional staffs, Treasury Department officials and the American Institute of Certified Public Accountants in the development of Subchapter S legislation. The Section of Taxation strongly supports enactment of S. 2350 with appropriate technical changes.

2. S. 2350 considerably simplifies Subchapter S and removes many of the complexities and restrictions which limited its use.

3. Increasing the number of shareholders and permitting differences in voting rights in common stock are desirable changes.

4. Potential application of Section 385 presents difficult problems. If debt is recharacterized as equity, corporations can lose eligibility as Subchapter S corporations.

(a) Straight "debt" issued for cash should never interfere with eligibility.

(b) Problems are more acute with hybrid debt. The Section suggests that hybrid debt issued for cash not be recharacterized as equity, unless over one-half of the value of the instrument is attributable to an equity feature that permits the holder to participate in the income of the corporation.

5. Elimination of the passive income test for corporations with no accumulated earnings and profits is desirable.

6. Corporations with accumulated earnings and profits should be able to elect either (a) to report those accumulations as long term capital gain taxable to shareholders over a five year period; or (b) to be subject to the passive income rules. The passive income rules should be appropriately modified.

7. The Section believes provisions in S. 2350 which would terminate Subhcapter S elections if corporations have foreign source income are unnecessary.

8. Provisions of S. 2350 defining timely elections, eliminating the power of a new shareholder to terminate an election, and allowing revocation of an election by a majority of shareholders rather than unanimous consent, are all desirable.

9. S. 2350 conforms a number of "operating rules" for qualifying Subchapter S corporations to existing rules for treatment of partnerships and partners. These changes are clearly desirable, as are requirements that allocate undistributed taxable income and net operating losses on a per-share, per-day basis.

10. The Subchapter S bill, S. 2350, is an important step in a continuing collegial process to simplify the Internal Revenue Code in specific areas affecting large numbers of taxpayers. The Section of Taxation enthusiastically supports its enactment with the modifications outlined.

STATEMENT OF M. BERNARD AIDINOFF, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION COMMITTEE ON FINANCE, UNITED STATES SENATE

September 10, 1982

S. 2350: THE SUBCHAPTER S REVISION ACT OF 1982

My name is M. Bernard Aidinoff. I am the Chairman of the Section of Taxation of the American Bar Association. I will present the position of the Section with respect to S. 2350, the Subchapter S Revision Act of 1982. I speak only for the Section of Taxation, which has a membership of approximately 25,000 lawyers engaged in tax practice; the American Bar Association has not adopted a position on this bill.

The Section of Taxation strongly supports the enactment of S. 2350. The Section has been intensively engaged in the development of this legislation over the past several years in a collegial process involving the staff of the Joint Committee on Taxation, the staffs of the House Ways and Means and Senate Finance Committees, the Treasury Department, and the American Institute of Certified Public Accountants. We are pleased that our joint undertaking with respect to Subchapter S is coming to fruition because it affects large numbers of small businessmen. It provides an opportunity through tax simplification to encourage new business undertaking and the allocation of capital to research, development, risk-taking, and employment in the most efficient possible manner without undue tax burdens.

Subchapter S dealing with "small business corporations" was first enacted in 1958 and has been amended on a piecemeal basis during the intervening years. It has been severely criticized, and has been under-utilized, because of the extreme complexity of its provisions. The reduction in individual tax rates, particularly the top individual rate from 70% to 50%, in the Economic Recovery Tax Act of 1981 makes Subchapter S potentially much more useful to small business, provided that some of the complexities and limitations in Subchapter S can be removed. S. 2350 will greatly simplify the rules relating to small business corporations. It represents a giant step forward.

In this statement, we address the basic merits of S. 2350, including, as requested by this Committee, the potential application of the section 385 regulations to Subchapter S corporations and the problems incident to the conversion of a corporation with accumulated earnings and profits to Subchapter S status. We are submitting separately a number of suggested technical changes to the bill.

The Subchapter S provisons were enacted into law in 1958 for the announced purpose of allowing businesses to select their legal form free of undue tax influence, aiding small business by taxing a corporation's income once to its individual shareholders, and permitting the shareholders of corporations that are suffering losses to offset such losses against the individual shareholder's income from other sources. To protect against possible revenue losses and potential abuses, various restrictions and limitations were imposed upon the availability of the Subchapter S election. Twenty-four years working with Subchapter S demonstrates that many of the restrictive provisions create hardships, anomalies, inadvertent terminations of elections, and unnecessary complexity.

Congress has dealt with certain of the problems by successive amendments to Subchapter S. It has been evident for some time, however, that overall simplification of the Subchapter S provisions is required. The Subchapter S Revision Act of 1982 substantially accomplishes that simplification.

ELIGIBILITY

S. 2350 increases the number of permitted shareholders of the Subchapter S corporation from 25 to 35. The increase in the number of shareholders will permit more widespread use of Subchapter S by small business. It will provide an additional margin of safety to avoid the permitted number being exceeded as a result of death of a shareholder and ownership by his heirs. We favor this change.

S. 2350 introduces a new concept, "ineligible corporation", to describe several categories of companies which will not be permitted to make a Subchapter S election. These categories include financial institutions, insurance companies, possession corporations, and corporations having DISC subsidiaries or foreign subsidiaries. We question the application of this provision to corporations with DISC subsidiaries or foreign subsidiaries. We see no necessity of excluding such parent corporations. The extent to which financial institutions or insurance companies should be excluded involves policy questions unrelated to the structure of Subchapter S, and we express no views as to the desirability or necessity of such exclusion.

S. 2350 also changes the existing provision excluding corporations which have more than one class of stock. Differences in voting rights in common stock would not violate the one class of stock requirement. This is a very desirable change, which we strongly support.

APPLICATION OF SECTION 385

The potential application of the Section 385 regulation to Subchapter S corporations presents difficult considerations. We are convinced that the Section 385 regulations as such, in whatever form promulgated, should have no automatic application to Subchapter S corporations. The question whether an instrument constitutes debt or equity affects several aspects of Subchapter S. Under S. 2350, this determination will affect the eligibility of shareholders, the allocation of income among shareholders and other investors and distributions to shareholders. Application of Section 385 will bring undesirable complexity and uncertainty to each of these areas.

We nonetheless recognize that problems exist in the debt-equity area that must be resolved. We also recognize that without any rules there would be equally undesirable uncertainty. In the case of "debt" being issued for cash to shareholders in proportion to their shareholdings, there should be no cause for concern or opportunity for abuse, whether or not the debt is "indebtedness" for federal income tax purposes. To the extent the debt is not held proportionately but is held entirely by shareholders, there also should be no concern. If the shareholders are unrelated, their roles as lenders will insure that there is an appropriate payment of interest as compensation for the loan. To the extent that because of the family or other relationships between lenders and shareholders there is an underpayment or overpayment of interest, this can be handled by appropriate allocation techniques already available to the Internal Revenue Service. There is no need to destroy the eligibility of the corporation for Subchapter S treatment. To the extent that straight debt is held by unrelated persons who are not shareholders, this fact itself should cause the debt to be recognized as indebtedness for income tax purposes, and in any event should not be permitted to endanger Subchapter S status.

The problems may be more acute when the purported debt instrument is a hybrid instrument having both debt and equity characteristics. If such an instrument is issued for cash and has a definite principal amount payable at a fixed time, we believe that it should be treated as debt for Subchapter S purposes, unless over one-half of the value of the instrument is attributable to an equity feature that permits the holder to participate in the income of the corporation. This test, taken generally from the proposed Section 385 regulations with respect to hybrid instruments not held proportionally to shareholdings, would be an appropriate test to be applied in lieu of any application of the Section 385 regulations or the existing case law.

PASSIVE INVESTMENT INCOME LIMITATION

Under present law, a Subchapter S election is terminated if twenty percent or more of the corporation's gross receipts consists of passive investment income. The termination of the election becomes effective for the year in which the passive income reaches this level.

One possible reason for this restriction was to limit the opportunity to incorporate investment activities for the primary purpose of obtaining tax deferral benefits provided by qualified pension, profit-sharing and other similar plans. This opportunity, however, was substantially reduced in the Tax Reform Act of 1969 by the imposition of an H.R. 10-type limitation on contributions to qualified plans made for an employee holding more than five percent of the stock of the Subchapter S corporation and has been further reduced by the creation of parity between qualified plans for self-employed individuals and employees in the Tax Equity and Fiscal Responsibility Act of 1982. Furthermore, because Subchapter S income is currently taxed to the shareholders, the receipt of passive investment income by a Subchapter S corporation does not subvert the purposes of the personal holding company provisions.

In view of the fact that the passive income limitation is no longer necessary and that it causes severe problems in the application of Subchapter S, the Section of Taxation strongly supports the proposed elimination of the twenty percent limitation for corporations which do not have accumulated earnings and profits at the close of the taxable year. This, however, does necessitate the consideration of special rules for corporations with accumulated earnings and profits which seek to elect Subchapter S.

CORPORATIONS WITH EARNINGS AND PROFITS ELECTING SUBCHAPTER S

If there were no special rules in Subchapter S to deal with corporations which have undistributed earnings accumulated in years in which Subchapter S did not apply, the following could occur -- (1) a Subchapter S election could be made by such a corporation; (2) the assets reflected by such accumulated earnings could be placed in a diversified portfolio of passive investments; and (3) the shareholders could receive the current income from such passive investments and be taxed only on such current income. The undistributed earnings of prior years, having incurred only the burden of a more favorable corporate tax regime, would not be taxed to the shareholders. The shareholders could enjoy the fruits of the undistributed earnings (*i.e.*, the additional earnings attributable to such additional assets) without incurring the shareholder tax on such undistributed earnings. Subchapter S without a passive income limitation would permit shareholders to defer indefinitely, or even ultimately to avoid, this shareholder level tax on undistributed corporate earnings while still enjoying the fruits of the shareholders' capital represented by such undistributed earnings.

S. 2350 in its present form would resolve this problem by requiring a corporation with accumulated earnings and profits which elects Subchapter S to remain subject to the existing passive investment income limitations (the twenty percent rule). We recommend instead a so-called two-track approach. Corporations with accumulated earnings and profits making a Subchapter S election would be required to elect either one of two tax regimes. Under one option, the corporation with the consent of its shareholders would elect to report its accumulated earnings and profits as income to its shareholders ratably over a five-year period. The shareholders would pay a tax at capital gains rates over the five-year period (twenty percent of the accumulated earnings and profits would be reported in each of the five years). The measurement of gain would be the lesser of the shareholder's share of accumulated earnings and profits or an amount equal to the gain that would have been realized if on the date of the Subchapter S election the shareholder had sold at fair market value all of his shares in the corporation. The corporation could then elect Subchapter S and be governed by all of the new rules, as provided in S. 2350.

In addition, since the accumulated earnings and profits of the corporation would become taxable to the shareholders by reason of such election, a capital gains tax on corporate income under proposed Code Section 1374 as contained in S. 2350 should not be required. The corporation in such a case would be treated in the same manner as a corporation that had elected Subchapter S from its inception. The taxation of the accumulated earnings and profits to the shareholders should, as hereinafter stated, permit corporations electing this treatment to be taxed under rules similar to the partnership rules with respect to the distribution of property in kind.

A technical explanation of this proposal, along with suggested bailout prevention rules, is included in the written technical changes that the Section of Taxation is submitting.

For those corporations with accumulated earnings and profits that elect Subchapter S but do not elect to have the accumulated earnings and profits taxed to the shareholders, rules for the "second track" should nonetheless be developed which will be as easy to administer as possible. Every attempt must also be made in such rules to avoid traps for unsophisticated taxpayers. We recommend that the corporations not electing taxation of their accumulated earnings and profits to shareholders be entitled to all of the benefits of the changes proposed in S. 2350 except those provisions which require special rules to deal with the existence of undistributed corporate earnings. Specifically, we recommend that different rules apply to such corporations that exceed a threshold level of passive investment income, to distributions in excess of current earnings, to property distributions, and with respect to proposed Code Section 1374 relating to certain capital gains.

In developing the threshold level of passive investment income, we recommend that the "personal holding company income" rules of Section 543 of the Code be applied as the standard. These rules are well-established and are familiar to tax advisers and even to many small businessmen. We recommend, however, that certain modifications be made as to certin types of rental and interest income that are clearly "active" income to certain corporations.

If a corporation in this situation has passive income in excess of the threshold level under our proposed modified personal holding company standard, the Subchapter S election should be terminated. Termination continues to be a particularly harsh result in those situations in which the threshold level of passive income is inadvertently exceeded, however, and as stated below we urge adoption of reasonable provisions to permit correction of inadvertent terminations.

FOREIGN SOURCE INCOME

S. 2350 would retain the restriction whereby a Subchapter S election is terminated if the corporation has foreign source income. This restriction is unnecessary and should be eliminated.

ELECTION, REVOCATION AND TERMINATION

The Section of Taxation supports the provisions of S. 2350 that a timely Subchapter S election for the current taxable year will be effective only if the corporation meets all qualifications for election from the beginning of the taxable year through the date of the election and if the shareholders during the entire period consent to the election.

The Section of Taxation also supports elimination of the requirement that a new shareholder may terminate the election by filing an affirmative refusal to consent.
A new shareholder who knows he is acquiring stock of a Subchapter S corporation should not have power to terminate

that election; it gives such a person undue leverage on the other shareholders and can easily be abused. In addition, and for similar reasons, we support elimination of the present rule requiring consent of all of the shareholders to revoke the election. The existing rule is too restrictive; minority shareholders should not be able to prevent a revocation sought by most shareholders. S. 2350 deals with both of these problems by appropriate means, and we strongly support these provisions.

Under present law, termination of a Subchapter S election applies retroactively to the first day of the taxable year in which a terminating event occurs (e.g., exceeding the maximum allowable number of shareholders or creation of a second class of stock). The Section of Taxation supports the change proposed in S. 2350 whereby an event occurring during the taxable year (other than excessive passive income in certain cases) causing a corporation to fail to meet the definition of a Subchapter S corporation would terminate the election only as of the day of the event causing the failure. The proposed rule will reduce the opportunity under present law for year-end manipulation by which shareholders can intentionally create disqualifying events to terminate the election retroactively to the first day of the year.

Under present law, terminations of elections occur even where the existence of the terminating event is entirely inadvertent. The results to the shareholders may be very harsh and may be unnecessary and inappropriate in the circumstances. An example would be sudden and unexpected business reversals which cause passive income to exceed the twenty percent level. There is a special rule in existing law to deal with this situation, but it is so narrowly drawn as to be inadequate in many cases. S. 2350 would give discretion to the Internal Revenue Service to allow a corporation to continue as a Subchapter S corporation notwithstanding an inadvertent termination. We strongly support this provision and suggest that the Service be encouraged to exercise its discretion fully and reasonably to avoid hardships.

OPERATING RULES

S. 2350 would provide significant improvements in the "operating rules" for qualifying Subchapter S corporations. Under present law, taxable income of a Subchapter S corporation is taxed at the shareholder level whether distributed or not, with net long-term gain being the only item retaining its character at the shareholder level. S. 2350 preserves the character of items of income, deduction, loss and credit to the shareholder in the same general manner as they pass through from partnerships to partners. This is a much improved approach which the Section of Taxation has endorsed for many years.

The Section supports revision of present law which allocates undistributed taxable income to shareholders only as of the end of the year while allocating net operating loss on a per-day basis. S. 2350 would require that all items be allocated on a per-share, per-day basis to anyone owning stock at any time during the year. This provides a more accurate allocation of income and prevents the abuses which can occur under current law with respect to shifting of income.

The Section supports the provisions of S. 2350 which would allow a shareholder to carry forward his share of the loss of a Subchapter S corporation to the extent that his basis is exceeded. This conforms to the partnership rule of permitting the loss to be carried over and deducted if and when the basis is restored.

Under existing law, adoption of a corporate fiscal year can be utilized under Subchapter S to defer the payment of tax on the first year's income from the business for as much as almost one full year. S. 2350 would conform the Subchapter S result to the partnership treatment and require adoption of a calendar taxable year unless the corporation can show a business purpose for another accounting period. The Section of Taxation endorses the adoption of these new taxable year provisions.

S. 2350 also would make substantial modifications in the taxation of distributions from a Subchapter S corporation. Under present law, the taxation of such distributions is governed by complex provisions with respect to "undistributed taxable income" and "previously taxed income". While shareholders are taxed on current income, distributions of income previously taxed are not taxed a second time. Special rules also apply to distributions of property in-kind.

With respect to property distributions, the Section of Taxation favors the distribution rule in proposed Code Section 1368 in S. 2350 for distributions from corporations which have accumulated earnings and profits and which have not elected shareholder taxation of such accumulated earnings and profits. The Section believes, however, that property distributions of capital assets from corporations which have elected shareholder taxation of their accumulated earnings and profits, or corporations which have always been Subchapter S corporations, should be taxed under rules similar to the partnership rules for the taxation of distributions of such property.

The changes proposed in S. 2350 as to distributions and basis, modified as we have suggested, would provide a much more logical and simplified method of taxing the income of a Subchapter S shareholder.

CONCLUSION

The Section of Taxation enthusiastically supports the enactment of S. 2350 with certain modifications. It is a product of a collegial process to simplify the Internal Revenue Code in specific areas which affect large numbers of taxpayers. The Installment Sales Revision Act of 1980 was a product of that collegial process and has proved to be a great success. This Subchapter S bill, S. 2350, is the next step in that process, and we feel certain that, with the modifications we have suggested, it will be an even greater success.

SUGGESTED TECHNICAL CHANGES

TO

S. 2350; THE SUBCHAPTER S REVISION ACT OF 1982

BY

THE SECTION OF TAXATION OF THE AMERICAN BAR ASSOCIATION

The following comments are being submitted by the Section of Taxation of the American Bar Association as a supplement to the written testimony to the Senate Finance Committee on September 10, 1982. Proposed new sections 1361 through 1379 are discussed separately.

SEC. 1361. S CORPORATION DEFINED

Summary

Proposed section 1361 corresponds essentially to the Internal Revenue Code of 1954 ("Code"), section 1371 in defining a corporation's eligibility to make a Subchapter S election. An electing corporation is defined as an "S Corporation"; a non-electing corporation is defined as a "C Corporation." The term "small business corporation" has a similar definition to that contained in existing law, with these changes:

-- The permitted number of shareholders is increased from 25 to 35 (corresponding to a prevalent securities law test for private placements);

-- Differences in voting rights among the shares of common stock specifically do not violate the single class of stock requirement.

-- The new term "ineligible corporation" is introduced to describe several categories of corporations which would not be permitted to make a Subchapter S election, some of which are eligible for election under existing law.

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Technical Comments.

Ineligible corporation defined.

Under existing law, if the requirements are otherwise met, a Subchapter S election is available to a domestic corporation which is not a member of an affiliated group for consolidated return purposes. This means that domestic banks, stock savings and loan associations, insurance companies, and possessions corporations are eligible to make a Subchapter S election. Moreover, an electing corporation may own 80% or more of any corporation which by the terms of code section 1504(b) is ineligible to join in a consolidated return. Permitted subsidiaries include insurance companies, foreign corporations, possessions corporations, DISCs and former DISCs. Proposed section 1361(b)(2) would deny S Corporation status to these categories of corporations, a significant change of approach. While existing law merely veers from the complexity of the consolidated return, the Bill veers also from corporations which have special items of deduction or credit.

The rationale for this change likely corresponds to the greater adherence in the Bill to the partnership model for the pass-through of items of deduction and credit. Such rationale appears valid in the case in which the S Corporation itself is in the special category; for example, one may question the pass-through of large additions to bad debt reserves or other special reserves. However, the rationale does not appear valid when applied to a subsidiary corporation which cannot join in a consolidated return. The subsidiary corporation could not pass-through specific items.

Whether financial institutions or insurance companies should be eligible to elect Subchapter S involves policy questions unrelated to the structure of Subchapter S. We express no views in this question.

We understand that a significant number of electing corporations do have DISC or former DISC subsidiaries and foreign subsidiaries. Without grandfather rights or other transitional rules, these electing corporations would suffer immediate termination of S Corporation status. That prospect suggests potential hardship and opposition to the Bill and we question whether sufficient policy grounds exist to require such results.

Certain Trusts Permitted as Shareholders.

Two technical corrections to proposed section 1361(c)(2)(A) should be considered:

-- Clause (i), permitting grantor trusts and certain other trusts to be shareholders of an S Corporation refers to an "individual." In community property states, the transfer to such trust by a husband and wife of their community property interests in electing corporation stock should not terminate the Subchapter S election.

-- Clause (ii) provides for a two year grace period in the case of such trust if the entire corpus is included in the estate of a deemed owner. The two year period should also apply in the case of such trust created by a husband and wife with community assets when one spouse dies, even though only the decedent spouse's share of the community property trust corpus is included in the decedent's gross estate.

A further point has been raised by the Internal Revenue Service in its proposed regulations under code section 1371(e) as published in the Federal Register on April 8, 1980. On the theory that the enactment of section 342 of the Revenue Act of 1978 constitutes an expression of congressional intent "to limit stock ownership in a small business corporation to direct and unqualified stock ownership, except for certain trusts meeting the statuatory requirements," the proposed regulations would provide that stock of an electing corporation may not be held as a split or partial interest such as a legal life estate, usufruct or remainder interest. We do not favor such new limits and suggest that the congressional intent be clarified in the legislative history pertaining to the Bill.

Differences in Common Stock Voting Rights Disregarded.

The matter of shifting or deferring income in a family context is adequately dealt with by the Bill:

-- Proposed section 1366(e) provides authority to adjust items taken into account by family members, within the meaning of Code section 704(e), in order to reflect the value of capital or services;

-- Code section 267 would be amended by adding a new subsection (f) to prevent deferral of income by reason of the accrual of unpaid expense, including interest expense, payable to a 2% shareholder or any person related to a 2% shareholder.

The 2% threshold appears to be extremely low. We believe that the percentage should be tied to a logical basis, which should be articulated in the legislative history. For example, a 10% threshold is used in code section 401(c)(3) to define an owner employee in the fringe benefits area.

We welcome the rule permitting differences in voting rights among shares of common stock. Other differences among shares might also be acceptable as long as differences do not:

-- Create doubt as to the person responsible to report income or loss;

-- Create undue administrative burden;

-- Cause income to be shifted or deferred among related taxpayers;

-- Permit ineligible persons to become equity holders when there is improper tax avoidance.

Some of the above were suggested by the Treasury Department in its 1969 proposals. We urge that consideration be given to the adoption of rules permitting separate classes of stock as long as the as the above principles are followed.

Hybrid Instruments.

There has been extensive discussion concerning hybrid debt instruments which in today's money market are more prevalent than they once were. These instruments carry so-called "equity kickers"; that is, their yields may include percentages of earnings or they may be convertible into stock in some manner. We urge that any determination about such instruments not be used to jeopardize an S Corporation election, and specifically, the proposed regulations under Code section 385 should not be applied as a test of Subchapter S eligibility. However, we acknowledge that hybrid instruments should not be allowed in effect to admit ineligible shareholders if there is improper tax avoidance. We believe this problem can be solved by including language that, for purposes of determining Subchapter S eligibility, an instrument which is not stock under the issuing corporation's charter would not be classified as stock unless the issuance has an improper tax avoidance purpose or effect which can not be adequately solved without termination of the election. Such rule should relieve most small business owners of the potential trap of Subchapter S termination upon securing legitimate loans with reasonable terms currently required by lenders; at the same time, cases of obvious abuse could be addressed.

Nevertheless, we strongly urge that no instrument issued for cash be deemed to be stock for any Subchapter S purpose unless over one-half of its economic value is attributable to an equity feature that results in an income participating yield, and otherwise results in improper tax avoidance.

C to S Problem.

We recommend that debt instruments recharacterized as equity during a C period continue to be so treated during an S period, but not for purposes of determining S Corporation eligibility, unless they otherwise present tax avoidance problems.

Securities Law Restrictions.

We recommend that a Subchapter S election not be terminated as a result of restrictions imposed upon shares by action of a governmental agency. For example, under the rules of the California Department of Corporations, a person receiving shares for services may be deemed a promoter with the result that restrictions are placed upon his shares -- e.g., that the promoter waive dividend distributions until the corporation becomes profitable. As a practical matter, no dividends are paid to any shareholder until the restrictions are lifted. In Page v. United States, 580 F.2d 960 (9th Cir. 1978), such restrictions were held to create a second class of stock, and the corporation's subchapter S electon was invalidated. On the condition that each shareholder (including the promoter) reports a pro rata share of current income and is entitled to eventual distribution of it, the restrictions imposed by a governmental agency should not terminate the election.

Qualified Subchapter S Trust.

This section attempts to restate Code section 1371(g). However, at the end of proposed section 1361(d)(3)(B) after the word "or" the phrase "resident of the United States, and" was inadvertently omitted. It should be noted that the Technical Corrections Bill of 1982, H.R. 6056, introduced on April 1, 1982, would modify certain aspects of this subsection. These suggested changes should be incorporated here.

Sec. 1362. Election; Revocation; Termination.

Summary.

Proposed section 1362 closely follows Code section 1372 with the following changes:

- -- The election period has been liberalized and specific rules have been included stating when the election takes effect.
- -- The termination rules have been relaxed by eliminating the requirement that all new shareholders concur in the election by filing a consent, and the passive investment income restriction will be applied only to those S corporations having earnings and profits at year end.

Technical Comments.

Election.

It is unclear whether proposed section 1362(a) requires the consent of a former shareholder who disposed of his stock during the year or the first 2½ months of the following year, or merely those shareholders who own stock as of the election date. This confusion stems from reading the daily pro rata allocation rules of proposed section 1377 in conjunction with the election provision. Likewise, no mention is made whether an election to take effect in the future may be rescinded by either the corporation or the consenting shareholders prior to the stated effective date. These concerns should be clarified in reports accompanying the proposed Bill.

Termination.

When proposed sections 1362(d)(1)(A) and (B) are read together, it is unclear whether the corporation may revoke, the shareholder may revoke, or both must concur in the revocation before it is effective. It is desirable to allow the corporation upon the concurrence of a specified percentage of the shareholders to revoke the election.

Effective Date.

No mention is made whether a revocation to take effect in the future may be rescinded by persons making the election prior to the stated revocation effective date. This should be covered in the Bill or the accompanying reports.

Passive Interest Income.

General.

De Minimus Rule.

Proposed section 1362(d)(3)(B) retains the exception for a corporation having passive investment income of less than $3,000 during the first taxable year in which it commences the active conduct of a trade or business or during the next succeeding year. The exception would appear to have less application in the context of new law; its application would be confined to a situation in which a corporation has just commenced the active conduct of a trade or business, but nonetheless has some E&P. Accepting the premise that such cases justify retention of a de minimus rule, in today's economy we suggest raising the amount to, say, $10,000.

Effective date of termination.

Although proposed section 1362(d)(3)(A)(ii) retains the rule that a termination occasioned by excessive passive investment income would be effective as of the first day of the taxable year, language in Code section 1372(e)(5)(A) referring to succeeding taxable years is deleted. Such deletion appears to facilitate the operation of proposed section 1362(f) providing for relief from inadvertent termination.

Comments on the Proposed Retention of a Passive Investment Income Restriction and Recommendations.

Background.

Following publication of the Joint Committee on Taxation, 96th Cong. 2d. Session, Staff Recommendations for simplifications of tax rules relating to Subchapter S Corporations (Joint Committee Print April 30, 1980)(hereinafter Joint Committee Staff Recommendations), concern was expressed that repeal of Code section 1372(e)(5) would give rise to a proliferation of private investment corporations. Attention has focused on the circumstance in which an existing corporation with earnings and profits ("E&P") sells its operating assets, reinvests the sales proceeds in passive investments, makes a Subchapter S election, and follows a course of distributing investment income without reaching E&P. Most who have expressed concern about this circumstance identify the E&P account generated during a C period as the source of problem. As a tentative solution, the Bill retains the passive investment income restriction, but applicable only to corporations with E&P.

Suggested first step: delete all S period E&P.

Pursuant to proposed section 1371(C)(1), generally no increase is made to an S corporation's E&P account; S period operations do not produce E&P. Consistent with this approach, for purposes of determining whether a passive investment income test applies, we recommend that the E&P account be reduced by any amount generated during a period in which a Subchapter S election was in effect. This simply acknowledges that during any S period, whether before or after the effective date of the Act, the electing corporation's income was taxed at individual rates. Consequently, there is not raised here the concern on which the retention of a passive investment income restriction is based. That concern properly focuses only upon E&P generated during a C period.

Suggested second step: modify the restriction.

Whatever further solution may be adopted, if a passive investment income restriction is retained for any purpose, we believe it should be modified as described below.

(a) PHC Definition. Experience under existing law has shown that numerous active businesses are prevented from making a Subchapter S election because the definition contained in Code section 1372(e)(5) is keyed to the type of income produced rather than the nature of the business activity producing it. For example, no distinction is made between interest income derived from bond coupons, installment obligations, and interest income earned by an active loan company. The loan company cannot maintain a Subchapter S election. Moreover, many active real estate businesses are barred from keeping an election because of rental income. One approach would be to shift emphasis to the word "passive", and adopt standards such as those contained in the Treasury Regulations under Code section 355 to distinguish the active conduct of a trade or business. However, such an approach requires difficult and recurring factual issues and it may be preferable to retain an objective test. We recommend that the "personal holding company income" rules of code Section 543 be applied as the standard. These rules are well established, and are familiar to tax advisers and even to many small business owners. We recommend, however, that certain modifications be made as to permit certain types of rental and interest income that are clearly "active" income to certain corporations.

(b) Alternative. If a standard similar to existing Code Section 1372(e)(5) is retained, we believe it should be modified as follows:

-- Exclude interest income generated by a lending or finance company (other than an excluded corporation) as defined in Code section 542(c)(6) and (d), and by an SBIC as provided in Code section 542(c)(8);

-- Exclude interest income derived from installment obligations received from the sale of property to customers in the ordinary course of business; and

-- Exclude rental income.

-- Increase the threshold to 60% to accord with the threshold in Code Section 542(a)(1) or to 50% by analogy to Code Section 1244. Further, a new rule could provide that the Subchapter S election is terminated only if the threshhold is exceeded for 2 of any 3 taxable years, and that such termination shall be prospective rather than retroactive.

-- Include in gross receipts only the gain portion of the sale proceeds of commodities held for less than one year. Such a rule would restrict the ability to shelter passive investment income by short-swing commodities trades.

Further Solution.

We believe an approach by which an S Corporation with E&P would be provided an election not to be subject to a passive investment income restriction should be considered. If such election were exercised with the consent of all shareholders, a capital gain would be recognized by each shareholder, measured by the lower of (1) such shareholder's share of E&P or (2) the amount of gain that would be recognized by such shareholder if the corporation were liquidated under Code section 331. To respond to potential liquidity problems, the gain could be recognized over a period of time such as five years. To limit potential abuse, if the Subchapter S election is terminated within the specified period, gain would be recharacterized as ordinary income to the extent of any distributions of E&P. Similar recharacterization would occur if the corporation liquidated pursuant to Code section 333.

We feel that the elective toll charge is an especially promising alternative.

Inadvertent Terminations.

It is unclear whether proposed section 1362(f)(3) is applicable to each termination event identified in proposed section 1362(f)(1). For example, termination occurs under proposed section 1362(d)(2) because the corporation ceases to be a small business corporation; proposed section 1362(d)(3) because of excessive passive income; and proposed section 1362(d)(4) because of the receipt of foreign income. To avoid any question as to the applicable scope of proposed section 1362(f)(3), the words "so that the corporation is once more a small business corporation" should be deleted and the words "to eliminate the event causing termination" should be substituted.

Foreign Source Income.

Proposed section 1362(d)(4) retains the restriction on foreign source income. We are not aware why. We believe the restriction should be repealed.

SEC. 1363. EFFECT OF ELECTION ON CORPORATION

Summary.

This proposed section adds totally new concepts. It combines certain parts of Code section 1372(b) and 1373(d).

-- The tax effect of the election on the corporation is redefined.

-- The elections permitted in other Code sections are divided between the corporation and shareholder.

-- A new rule is adopted regarding distributions of appreciated property.

Technical Comments.

Elections.

We do not understand why proposed section 1363(c)(2) contains no reference to Code section 57(c). We feel this should be added to conform the election under this proposed section with Code section 703(a)(2).

Taxable Income.

Proposed section 1363(b) should be coordinated with proposed section 1374(d), and one or the other eliminated. We perceive no reason for two distinct definitions for taxable income of an S corporation.

Appreciated Property Distributions.

General.

While we welcome the addition of this proposed subsection for corporations having accumulated E&P, we believe it does not go far enough. This proposed section should cover losses on the distribution of property as well as gains.

We strongly urge that this proposed subsection be limited to S corporations having accumulated E&P. As with partnerships, non-terminating distributions of long-term capital gain appreciated property should not give rise to tax at any level when there has been no buildup of value through accumulated E&P. Then, as with partnerships, carryover basis rules should be employed at the shareholder level for such distributions. Other types of S corporation distributions for non-accumulated E&P should also follow partnership rules.

Further, it is not clear what the reference to coordination with Code section 311 is designed to accomplish. We suggest proposed section 1363(d)(2) be clarified in this regard.

Recapture and Other Rules.

No apparent consideration has been given to coordinating the tax imposed under proposed section 1363(d) with the recapture tax provision of Code sections 49, 1245 and 1250. Under no circumstances do we believe a double tax is justified on a distribution of appreciated property.

If it is contemplated that the Subchapter C liquidation provisions override the Subchapter S provision there must likewise be some coordination with Code section 1239 to avoid double taxation.

Code Section 331.

It is not clear whether a distribution under Code section 331 is excluded from proposed section 1363(d)(3). This should be clarified.

Section 1366. Pass-Through of Items to Shareholders.

Summary.

This proposed section modifies current law in that the character of the items of income, deduction, loss and credit are passed through to shareholders in the same general manner as they pass through in partnerships. Excluded are certain capital gains adjustments and allowable credits under Code Section 39. It also adds new rules to permit the Treasury Department to make adjustments when services are rendered or capital is provided by family members to prevent undesirable income splitting.

Technical Comments.

General.

To avoid the unnecessary confusion on the part of small businessmen, we suggest the following changes:

-- Add the words "as defined in Section 1377" after "shareholders prorata share", in proposed Section 1366(a)(1).

-- Add the words "by the shareholder" after the words "such items were realized", and after the words "or incurred in proposed Section 1366(b)."

-- Add the words "as defined in Section 1377" at the end of the last sentence in proposed Section 1366(d)(3)(A).

Other.

It is unclear to us why reference to debt is omitted in proposed Section 1366(d)(3)(B). We preceive no policy reason for this omission. In addition, the reference to debt makes this proposed subsection consistent with proposed Section 1366(d)(1).

We do not understand the reason for excluding the credit allowed under Code Section 39 in proposed Section 1366(f)(1) while on the other hand permitting the credit in proposed Section 1374(b). Such technical nicities merely confuse the small businessman.

Section 1367. Adjustments to Basis of Stock of Shareholders, Etc.

Summary.

The proposed section 1367 basis adjustment rules closely follow the partnership basis rules set forth in Code Section 705 except for income items which are not included in the gross income of an S corporation shareholder, and are not shown on his return.

Technical Comments.

If the desire is to provide for the greatest likeness possible, and also avoid confusion between the S corporation and a partnership it seems that non-taxable items of income such as tax-exempt interest should be as available to a stockholder as to a partner. To carry out this purpose the provisions of paragraph (1) of Section 1367(b) should be expanded to include as income all items of income as defined by subparagraph (A) of Section 1366(a)(1) without any requirement of the inclusion of the items in the gross income shown on the shareholder's return.

By comparison, if an S Corporation realizes tax-exempt interest income, the distribution can result in the shareholder being required to report capital gain income after his basis has been recovered whereas in a partnership such income can be earned at the partnership level and distributed to the partner without any such possible income realization. It appears that this restrictive provision is present only to prevent an S Cororation from investing its funds in tax-exempt obligations and avoiding the distribution of its accumulated earnings and profits. A solution to this possibility is to provide in Section 1368(c) a new subparagraph (1) which states that

> "That portion of the distribution which does not exceed the undistributed accumulated gross income realized by the S Corporation on any tax-exempt obligations shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S Corporation."

It will then be necessary to renumber the remaining subparagraphs to "(2)" and "(3)" in lieu of (1) and (2).

By adopting this order of distribution, a shareholder would still have a part of the future basis of his stock available to be recovered through distributions (like a partnership) without realization of a capital gain (the same as a partner would) but, at the same time, S Corporation status would not be elected just to realize passive tax-exempt income without being required to distribute its accumulated E&P. This additional provision does not create a tax-trap for the S Corporation without E&P and provides similar treatment for tax-exempt income as would be realized by a partner, and will prevent a tax loophole in this Bill.

If the above concept is adopted, subparagraph (1) of proposed section 1367(b) should be deleted and the subsquent two subparagraphs renumbered.

We perceive no reason why the coordination provision of proposed section 1367(b)(3) should be limited to stock. We believe this subsection should be expanded to include debt described in Code Section 166.

Section 1368. Distributions.

Summary.

This proposed section contains entirely new rules which describe separately the effect of a distribution:

- On S Corporations having no E&P;
- On S Corporations which have E&P due to prior C periods; and
- Introduces the concept of an accumulated adjustments account.

These new rules are necessitated because of the desirability of permitting the distribution of appreciated property, and avoiding the adoption of complex rules akin to Code section 751(b).

Technical Comments.

General.

When the rules under this proposed section are read in conjunction with the proposed section 1379 transition rules, a tax trap for the unwary, unsophisticated, small businessman arises. These rules in essence provide for a one year period in which previously taxed but undistributed income of a previously electing Subchapter S Corporation may be withdrawn without being taxed twice. This transition rule may be confiscatory even to the best advised shareholder because they may not be able to make the distribution within the required one year period.

We highly recommend that:

- -- The transition rule of proposed section 1379(c) be amended to permit unlimited withdrawals of previously taxed but undistributed income ahead of accumulated earnings and profits; or
- -- The accumulated adjustments account be refashioned to include all previously taxed but undistributed income.

Accumulated Adjustments Account.

After examining the definition of the "accumulated adjustments account" in proposed section 1368(e)(1) we are uncertain what those "similar adjustments" described in proposed section 1367 are, and how they would be applied to arrive at the computed accumulated adjustment account balance. Certainly one cannot expect a small businessman to devine what is meant. The failure to spell out these adjustments may promote unnecessary and time consuming audit adjustments.

We strongly recommend that the Congress describe with particularity the nature of each item making up the accumulated adjustments account, and how the increases and decreases in the accumulated adjustment account will work.

S Period.

We recommend that the term S period include the period from January 1, 1959, or the date a Subchapter S election was made, if the election was in effect as of the effective date of this Bill.

Section 1371. Coordination with Subchapter C.

Summary.

This proposed section has no counterpart in prior law. It adopts rules with respect to:

- -- Application of Subchapter C to an S Corporation.
- -- Carryovers between C year and S year corporations.
- -- Adjustments to the earnings and profits account.

- -- Coordination of the investment credit recapture rules.
- -- Distribution by the corporation after a terminating event.

Technical Comments.

Earnings and Profits.

The Joint Committee Recommendations at 18 states that after enactment of the Bill, if a Subchapter S election is in effect, the corporation would have no earnings and profits for that year. Although we understand this concept is intended to be in the current Bill, it is not explicitely set forth in proposed section 1371(c)(1). This proposed section should be revised to include this important concept.

Cash Distribution.

Proposed section 1371(e) must be read in conjunction with proposed section 1377(b) which defines the post-termination transition period. The permitted one year period for withdrawing S year undistributed income is too short for an operating company. The shareholders in small corporations bear an unjust burden when the corporation cannot timely liquidate assets to meet the one year cash rule. They would never be able to withdraw previously taxed but undistributed income except when their stock in the corporation is sold.

At a time when Congress is wrestling with ways to reduce the government burdens on small business, another alternative may be to incorporate a reordering provision which allows such distribution to come ahead of a distribution out of accumulated earnings and profits if termination occurs.

We believe the better solution is to extend the withdrawal period for an unlimited time period.

Section 1372. Coordination With Part I Of Subchapter D, Etc.

Summary.

This proposed section takes completely away all of the fringe benefits regular corporations enjoy.

- -- The $5,000 death benefit exclusion (Code Section 101).

-- The exclusion from income for amounts paid from accident and health plans (Code Section 105).

-- The exclusion from income for amounts paid an employer to an accident and health plan (Code Section 106).

-- The group-term life insurance exclusion of up to $50,000 on an employee's life (Code Section 79).

-- The exclusion from income of meals or lodging furnished for the convenience of the employer (Code Section 119).

Technical Comments

General

During the last ten years Congress has been very much concerned about employee fringe benefits. It has adopted the Employees Retirement Income Security Act of 1974, P.L. 93-406, 93rd Cong. 1st Session (1974); and has adopted extensive anti-descrimination rules in other fringe benefit areas. The principal objective of Congress should be to place all employees on the same footing regardless of the choice of business entity the employer selected. Both partnerships and S corporation employees should be permitted to enjoy the same fringe benefits as their C corporation counterparts.

If Congress, in its wisdom, feels that fringe benefits are too great of a revenue loss, they should repeal the fringe benefits for all, not just a select few.

We feel that this proposed section should be deleted in its entirety.

Section 1373. Foreign Income.

Summary.

This proposed section has no counterpart under current law. It identifies those instances when an S corporation will be treated as a partnership, and the making or terminating of an S election triggers the recapture of overall foreign losses.

Technical Comments.

Recapture.

We do not understand why the making or terminating of an S election should be treated as a disposition of a business. We believe there may be better alternatives.

Section 1374. Tax Imposed on Certain Capital Gains.

Summary.

Proposed section 1374 is divided into four subsections. The first three follow nearly word for words subsections (a), (b) and (c) of Code section 1378, which imposes a tax at capital gains rates on certain corporate transactions. The fourth subsection is new, and is made necessary by the changed concept of S corporation taxable income introduced by proposed sections 1363 and 1366. For purposes of retaining the corporate level tax on certain S corporation long term capital gains, proposed section 1374(d) creates a second computation of taxable income, requiring it be calculated as in the case of C corporations, but without the net operating loss deduction of code section 172, and without the special deductions for corporations other than for organizational expenses.

Although many believe present section 1378 is ineffective in accomplishing the objective to which it was directed (preventing a C corporation from electing under subchapter S before a sale of capital gain property to avoid the two tier tax), continuing the tax is appropriate in the context of the current Bill. However, if the proposal to eliminate C corporation accumulated earnings and profits through a toll charge is adopted, proposed section 1374 must be limited in application to those S corporations which have accumulated earnings and profits and which do not elect to pay the toll charge.

We propose, with respect to proposed section 1374 imposing a corporate level tax on the S corporation with substantial capital gain, a somewhat broader application than S. 2350 provided as to a corporation with E&P electing S corporation status but not electing to pay a toll charge at the shareholder level to purge itself of accumulated E&P. It should apply if the election has not been in effect for at least five years. It should also apply to an installment sale made during the five year period following the S corporation election to the extent principal is paid during the five year period.

Technical Comments.

Taxable Income Determination.

Proposed Section 1374(d) uses a different set of rules for calculating taxable income than is used under proposed sections 1363 and 1366 in determining the amount of the shareholder's pass-through income. This complexity seems unnecessary. We suggest that proposed section 1363 rules for calculating taxable income (since the calculations must be made anyway), without the subsection (c)(2) exceptions, is far more simple and will not provide a distorted result.

The reference to "Part VII" in proposed section 1374(d)(2) should be a reference to "part VIII."

Section 1375. Administration.

Summary.

This proposed section has no counterpart in current law. For ease in administering the tax laws an entity level audit aproach is adopted. The tax treatment of any Subchapter S item of income, loss, deduction, or credit is determined at the corporate level. Provision is made for each shareholder to participate in any administration or judicial proceeding to determine such items.

Technical Comments.

Proceedings.

Proposed section 1375(c) does not explain what is meant by an "opportunity to participate." Is it contemplated that each shareholder and his authorized representative will be permitted to comment upon, be present during, or be a party to, each and every contact between the IRS personnel and the corporation? To avoid unnecessary and unproductive use of monetary resources and time of both the taxpayer and the government, the phrase "opportunity to participate" should be defined.

Recommendation.

Proposed section 1375(d) should clarify what rules will be in effect until the Secretary's recommendations are acted upon by Congress. Furthermore, this proposed section should require that such recommendations be submitted in written form, and that further public hearings be held regarding the Secretary's recommendations.

This proposed subsection does not address how a shareholder's individual rights are to be protected in an audit. This omission greatly concerns the Section of Taxation. The Secretary should be directed to include such recommendations in his report.

Section 1377. Definitions and Special Rule.

Summary.

The definitions in this proposed section are new. They have no counterpart in current law. The terms "prorata share" and "post-termination transition period" are defined, and the Secretary is given authority to adopt regulations governing the manner in which the Subchapter S election is to be made.

Technical Comments.

Termination Election.

Upon termination, proposed section 1377(a)(2) permits split taxable years upon the unanimous consent of all shareholders during the year. This rule is too inflexible. It should be modified to require the unanimous consent of all shareholders as of the date the tax year is to be split. Consent of those persons who become shareholders after the effective date of the split year should not be able to upset the carefully laid termination plans of shareholders as of the date of termination.

If the potential shareholders do not like the split year, they need not become shareholders.

Transition Period.

The time lapse between the date identified in proposed section 1377(b)(a)(A) and 1377(b)(1)(B) may be several years. If the statute of limitations for an audit hasn't run, does this mean the transition period, as a minimum, is extended for the length of the statute of limitation period? This apparently is the intent of this language. If something else is intended, this statutory language should be modified to reflect this.

Section 1378. Taxable Year of S Corporation.

Summary.

Under current law a Subchapter S corporation is permitted to select its accounting period in the same manner as a C corporation. Except for grandfather provisions, this proposed section would force all S Corporations to elect a calendar year.

Technical Comments.

Grandfather rights.

We believe the grandfather clause set forth in proposed section 1378(c)(3) is much too harsh. A corporation should not be forced to adopt a calendar year reporting period when a shareholder transfers stock to his spouse or other family members for estate planning purposes. The adoption of an attribution rule would be a desireable result.

Section 1379. Transitional Rules on Enactment.

Summary.

This proposed section establishes rules for carryforwards and distributions of undistributed taxable income during the year in which the Bill became effective.

Technical Comments.

We feel strongly that proposed section 1379(c)(1) should be modified to permit distribution of undistributed but previously taxed income without any fixed time limit. To do otherwise would subject the small uninformed businessman to a double tax on such distribution. The rule as presently drafted destroys the single tax concept which an electing Subchapter S shareholder thought he had acquired since enactment of Subchapter S in 1958. By keeping the rule as presently drafted Congress will loose faith with small businessmen throughout the country.

COMMENTS

PRESENTED TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
HONORABLE ROBERT DOLE, CHAIRMAN

SUBCHAPTER S REVISION ACT OF 1982
S. 2350

SEPTEMBER 10, 1982

BY
WILLIAM T. DISS
CHAIRMAN
SMALL BUSINESS TAXATION SUBCOMMITTEE

FEDERAL TAX DIVISION
THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

INTRODUCTION

The AICPA Tax Division welcomes this opportunity to comment on S. 2350 the Subchapter S Revision Act of 1982. This legislation largely reflects the April 30, 1982 Joint Committee print containing the "Staff Recommendations for simplification of Tax Rules Relating to Subchapter S Corporations," prepared by the Staff of the Joint Committee on Taxation for the use of the House Ways and Means Committee and the Senate Finance Committee.

This Joint Committee print, as does the pending legislation, reflects the bi-partisan, non-controversial efforts of the staffs of the House Ways and Means Committee, Senate Finance Committee, and the Treasury to simplify and improve the tax laws, as well as input from the AICPA Tax Division and the American Bar Association Federal Tax Section.

The legislation is the second in a series of "simplification" measures initiated by these committee staffs and Treasury, with advice from the professional tax organizations, and is similar to the 1980 Installment Sales Revision Act in this regard. In general, the AICPA recommends that the legislation be conformed, as nearly as possible, to the Joint Committee print.

The AICPA supports the amendments made to H.R. 6055 by the House Select Revenue Measures Subcommittee, but reiterates its recommendations for the following further amendments:

- Rent should be added to the category of permissible "passive receipts", in addition to the finance company income approved by the House subcommittee.
- Accelerated income reporting by the two percent or larger stockholder should be substituted for the deduction deferral for salary, rent or interest payable to the stockholder. This would conform the reporting to the guaranteed payment rules for partnerships, and avoids the burden on other stockholders of the deduction deferral.
- Employee fringe benefits should be continued for a corporation that satisfies the existing law 20 percent passive receipts limitation.
- The fiscal year conformity requirements should be waived for such corporations, or at least a September 30 or later fiscal year end permitted. Contrary to partnerships and fiduciaries, the stockholder deferral from a corporation fiscal year end relates only to undistributed taxable income.

Summary

The American Institute of Certified Public Accountants Tax Division ("AICPA") supports in particular the three major improvements appearing in the legislation -- repeal of the passive receipts test, elimination of election period earnings and profits, and provision for carry over for unused shareholder loss allocations. In addition the AICPA supports other improvements such as:

- Enlargement of the shareholder numeric limit
- Requirement of majority in shares for revocation of the election
- Relaxation of the old law previously taxed income lock-in rules
- Elimination of the "Catch 22" result for a late-filed election
- Unification of the per share/per day profit and loss allocation to shareholder computation
- Provision for tax administration and settlement related to the corporate entity.

The AICPA has certain reservations regarding the following:

- Cash basis rule for expenses paid to 2% or larger shareholders (added to the legislation shortly before its introduction)
- Repeal in 1985 of fringe benefits for these stockholders
- Fiscal year conformity
- Constructive gain on in-kind property distributions
- Split year Subchapter S to Subchapter C reporting
- Continuation of the 80% foreign receipts limitation.

Consideration should be given to further refinements such as a more comprehensive provision for cure of Subchapter S disqualifications; imposition of all investment credit recapture at corporate level; and a specific provision for stock owned by a life tenant, or in any form of life estate or usufruct. A comprehensive solution should be sought for all stock ownerships affected by community property rules.

Debt-Equity Regulations

We recommend that specific regulatory authority be added to S. 2350, which would permit the Internal Revenue Service to reclassify a hybrid instrument which has the economic effect of stock but only when the holder of this instrument would be an ineligible stockholder of an electing Subchapter S corporation e.g., foreign person, another corporation, permanent trust, etc. This provision would be appropriate in order to prevent evasion of the stockholder eligibility rules. We assume for this purpose that variable interest and infaltion provision notes would not be considered hybrid instruments.

We oppose reclassification of debt as stock where the purpose is to reallocate a Subchapter S corporation loss to the holder of the debt instrument. Local law and economic reality should impose the burden of the corporation's loss on the stockholder and not the debt holder. Furthermore, we recommend that Subchpater S corporations otherwise be eliminated from the operation of any regulations finally adopted under §385.

Converting Corporation

Subsequent to the issuance by the Joint Committee on Taxation of its April 30, 1980 bi-partisan, professional consensus report, the ability of a regular corporation reporting under Subchapter C, to elect Subchapter S treatment was challenged by two commentators. Continuation of the 20% passive receipts limitation for a corporation with accumulated earnings and profits was intended to serve as a provisional solution to their concerns.

The first critic noted that elimination of the passive receipts test permitted a private or family investment company an outlet from the usual personal holding company restrictions.

The AICPA believes that the concern of personal holding company avoidance is not well taken. The family investment company can arrange for most of the gross income of the corporation to be dividends subject to at least the 85% dividends received deduction, largely eliminating the double taxation of the family's earnings. Family financial or estate planning and corporate estate planning often are better accomplished by use of a personal holding company ("PHC") inasmuch as recapitalization plans permitting the older generation in the family to hold preferred stock are permitted for a PHC.

However the Congress may conclude that a new law "S corporation" could avoid the detailed restrictions imposed when regulated investment companies were authorized to hold portfolios concentrated in municipal bonds. A personal holding company is unable to distribute dividends to its shareholders, sourced upon municipal bond interest income, without having such distributions treated as taxable dividends. Accordingly Congress might wish to continue the concept of election year current (excess) earnings and profits as to municipal bond interest income only, with a sourcing priority for actual dividends from this income, then require that such distributions be treated as taxable dividends by the recipient stockholders.

The second critic has urged that the election be treated as a constructive liquidation, deemed dividend, or combination of both. He argues that the conversion from "C" to "S" status should be treated as if the corporation had liquidated and the former stockholders joined together as partners as an investment company.

The AICPA believes this proposal is unwise, and represents an unacceptable complication in the income tax law. More important, we do not perceive any tax abuse potential for converting corporations. The earnings and profits accumulated to the election date remain in "corporate solution" and any distributions therefrom to the stockholders are taxed as ordinary dividend income under existing law, as well as the proposed legislation. Any shareholder withdrawals that might occur during the election period can only relate to "S year" earnings, and not to the accumulated earnings and profits.

Furthermore we see no policy difficulty in permitting a family corporation to report either under Subchapter S, or as a personal holding company. The Congress might well conclude that it is desirable to permit the continuation of closely held corporations with investment portfolios rather than fostering continued concentration of financial wealth in larger corporations, through mergers and acquisitions.

However if Congress concludes that conversion from "C" to "S" status with continued corporate existence and activities related to investments, rather than an active trade or business, should be restricted, we reluctantly recommend a different solution, viz. that a corporation otherwise subject to the PHC rules because of its closely-held stock and more than 60% of its adjusted ordinary gross income derived from passive investment sources, be ineligible to elect the new law "S corporation" status, unless a "toll charge" on accumulated earnings and profits is elected by the corporation.

This compromise has the merit of permitting small corporations and their tax advisers to rely upon well settled current PHC rules, which include corrective planning provisions. If essential, this compromise can be coupled with the possible continuation of the current earnings and profits rules, described above, for municipal bond interest income.

In lieu of the compromise described above for ineligibility of a PHC to elect "S corporation" status we suggest as a partial solution to the present law difficulties arising from the passive receipts limitation, a revised definition to treat as active receipts, i.e. non-disqualifying income the following:

- All rents
- Interest received by a corporation which qualifies for the finance company exceptions to personal holding company status
- Interest received by a personal property dealer on notes and accounts taken upon the sale of the dealer's inventory.

To summarize, the AICPA believes that existing law is adequate. Proponents of the "toll charge" on accumulated earnings and profits ignore the decisive differences between a Subchapter S election and the hypothesized liquidation and reincorporation as a personal holding company--the absence of basis to step-up for assets, and the retention of all assets, including cash, in corporate solution. However, we can support a provision under which a personal holding company is ineligible to make a Subchapter S election unless it agrees to make a toll charge on this accumulated earnings and profits.

This support is confined to the proposal which we believe has been endorsed by the American Bar Association Tax Section and which entails long-term capital gain reporting and tax payment over five annual installments. We observe, however, that the planning flexibility which this toll charge procedure permits might be undesirable policy, because of the resulting complications in the tax law.

Other Issues

The AICPA believes that continuation of the current restriction of one class of outstanding stock is desirable. In general, allowance of two classes of outstanding stock would create undesirable complications in the allocation to shareholders of the corporations's earnings and losses. However we do support provisions of the legislation that permit one class of stock with variation in voting rights.

The "thin capital" doctrine should not be re-imposed on electing corporations. The Congress is aware that the courts have overwhelmingly concluded that this doctrine should not be applied to create a second class of disqualifying stock. Furthermore even a cursory review of the regulations re-proposed under §385, now postponed again, suggests that an electing "S corporation" should not be burdened with the complications shortly to be visited upon the "thin corporation" doctrine. Indeed we believe the Internal Revenue Service would be well advised to exclude from these proposed regulations instruments issued by an "S corporation" during an electing year.

We believe that the continuation of the 80% foreign receipts limitation is unnecessary. The limitation appears to coordinate with §861 (a)(2) which provides foreign source treatment for dividends by a domestic corporation which realizes more than 80% of its gross income from foreign sources. Inasmuch as the pending legislation permits a flow-through of the foreign tax credit to an electing corporation's shareholders, we believe this particular limitation no longer serves its original purpose, and should be repealed.

In regard to fringe benefits, we note that the Joint Committee print would have permitted continuation of these benefits for stockholders of an electing corporation which satisfied the 20% passive receipts test. Another possibility would be to repeal fringe benefits only for a personal holding company. We understand that this limitation was added to the original 1958 legislation in order to prevent an investor from incorporating his portfolio, then establishing employee retirement and fringe benefit plans. Subsequent amendments to Subchapter S have permitted retirement plans subject generally to the proprietorship and partnership plan contribution limitations.

There remains the disparity between an electing corporation and a partnership for fringe benefits but the AICPA does not support this means of eliminati the disparity. We observe, for example, that one difficulty the small business firm faces is the inability to afford the same sophisticated employee benefit package that large corporations offer their executives. Instead of this step backward, Congress should consider extension of fringe benefits to partnerships and proprietorship.

The AICPA had suggested that the fiscal year conformity rule be applied only for a corporation which would otherwise be a PHC, or possibly not a largely operating company within the meaning of §1244 small business stock regulations. The purpose was to avoid an artificial deferral of investment-type income by a corporation newly eligible to elect. An existing operating company on a fiscal year should not involve the same policy feature. We now recommend that a fiscal year ending on September 30 or later in the calendar year be permitted, as provided in the Joint Committee print to accomodate return preparer workloads and reduce the number of individual return extension requests.

Existing Problems and Solutions

The AICPA notes the following problems under existing law and supports the solutions, as annotated to the pending legislation.

1. Current earnings and profits (Subchapter S election year earnings and profits in excess of taxable income or "CEP") §1371 (c).
   - CEP from life insurance proceeds and from depreciation differences caused by §312 (k).
   - Shareholder taxation for dividends in property, or cash dividends exceeding taxable income.
2. Passive receipts limitation — §1362 (d)(3)
   - Fine distinctions between rents and occupancy charges.
   - Unavailability of Subchapter S to real estate or finance companies.
   - Inadequate safe harbor for passive receipts by a start-up company.
3. Wastage of unused loss allocations to shareholders (in excess of stock and loan bases) — §1364 (d)(2).
4. Unintended income upon repayment of reduced basis stockholder loans — §1367 (b)(2)(B).
5. PTI lock-in after a Subchapter S termination from disqualification — §1377 (b).
6. UTI allocation where mid-year stock sale, and uncertainty as to full year's earnings — §1377 (a).
7. Acceleration of shareholder income for a fiscal year corporation, upon the payment of an "advance" dividend — §1377 (a).
8. Untimely (late) election for current year treated as too early for succeeding taxable year — §1362 (b)(2).

9. Stock redemptions and partial liquidations do not reduce UTI or CEP — §1368 (e)(1)(B).

10. Fragmented return examination and settlement — §1375.

However we note that a number of problems under existing law have not been resolved in the pending legislation. We recommend that Congress address these problems in the pending legislation or if this is impolitic, then for a supplemental bill in the next session. Items the AICPA particularly recommends for attention include the following:

1. Pre-date of death UTI under existing law does not qualify as income in respect of a decedent. We believe the same unavailability of §691 deduction applies to the accumulated adjustments account balance incorporated in the pending legislation. The undistributed earnings allocated to the shareholder, at least for the year of death, should be treated as income in respect of a decedent inasmuch as such earnings are taxed both for Federal estate and Federal income tax purposes.

2. The distribution rules in new §1368 should be coordinated with the post-termination transition period rules of new §1377 (b) to permit distributions from the accumulated adjustments account within the transition period.

3. Provision should be made in new §1368 to reduce accumulated earnings and profits for distributions sourced thereon and made during the calendar month of a §333 liquidation.

4. A comprehensive solution to community property stock ownership should be provided, to treat such stock as owned by one, eligible stockholder for all purposes of Subchapter S.

Doubtful Policy Decisions

The AICPA acquiesced in certain policy decisions, in order to achieve the consensus reflected in the Joint Committee print. However if the Congress decides to depart in significant respects, e.g., by inserting provisions related to a "converting corporation" from this Joint Committee print we note certain of our reservations related to the following policy resolutions incorporated in the print and in the pending legislation:

1. Split-year Subchapter S and Subchapter C reporting. We had recommended that a rule, similar to the pending legislation for revocation be applied, i.e., depending upon the timing of the disqualification event, the termination be effective either on the first day of that year, or the first day

of the succeeding year. Imposition of the split-year reporting is a considerable complication for the corporation and its shareholders, including the dual computations of income under the daily proration and the cut-off methods, annualization of the short "C year," etc., and permits manipulation by staging the disqualifying termination event.

2. Cash method for expenses to shareholders. As previously noted this provision was not in the Joint Committee print but was added to the pending legislation shortly before its introduction. This limitation complicates the accounting for a corporation that has numerous employees owning at least 2% of the outstanding stock, and penalizes all shareholders by increasing their net reportable incomes. Congress should consider whether this complication is necessary; if it is, the rule should be extended to §707 (a) payments made by a partnership to a partner in a capacity other than as a partner, or by accelerating the particular shareholder's reporting similar to the §706 (a) timing for a §707 (c) guaranteed payment.

3. Disqualification cures. If the passive receipts limitation is continued in the law, at whatever level, consideration should be given to a more comprehensive disqualification cure, either entailing taxable dividend distributions to the shareholders, or a corporate level tax on the excess passive investment receipts. Such curative provisions are consistent with the inadvertent termination relief included in the pending legislation.

4. Constructive sale on distribution of appreciated property. We acknowledge the need for an anti-bailout provision but had previously recommended imposition of a carryover basis rule for distribution of appreciated property to a shareholder. This would require taxation of the unrealized gain upon resale by the stockholder.

5. Investment credit recapture. A considerable simplification could be achieved if the corporation is made responsible whether reporting as a "C corporation" or a "S corporation" for investment credit utilized by the corporation at corporate level for any year, or by shareholders for any election year. The corporation can maintain the records in a central location to facilitate the identification of property which has been early disposed or for which there has been an early cessation.

As explained above, however, the AICPA is prepared to support the pending legislation as introduced, provided that substantial alterations are not inserted to generally mandate shareholder taxation of undistributed accumulated earnings and profits of a "converting corporation."

* * *

Thank you for this opportunity to submit the AICPA's comments on S. 2350.

The CHAIRMAN. Again, I have no questions. I think we are going to be working with you and members of our staff after we have finished the witnesses. We appreciate your efforts. I know they have been long and arduous if what my staff tells me is accurate.

We would like to get this done this year, and I assume that is your hope, too. Is that correct?

Mr. AIDINOFF. It certainly is.

Mr. DISS. Enthusiastically.

The CHAIRMAN. OK. Well, I appreciate it very much. Thank you.

Mr. AIDINOFF. Thank you, Mr. Chairman.

The CHAIRMAN. Our next panel consists of Donald Alexander of Morgan, Lewis & Bockius on behalf of the chamber of commerce; Mike McKevitt, director of Federal legislation, NFIB; and Walter Stults, president of the National Association of Small Business Investment Companies, Washington, D.C.

I wonder if you would hold just for a second. I need to call Senator Baker here.

[Recess taken.]

The CHAIRMAN. Let me indicate to the panel, I am hoping I might have some relief here but Senator Baker is asking me to help him on another little matter like a veto, so if you can help me by summarizing your statements and making the key points, I would appreciate it.

Mr. Alexander, you are first.

STATEMENT OF DONALD C. ALEXANDER, MORGAN, LEWIS & BOCKIUS, ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES, ACCOMPANIED BY DAVID E. FRANASIAK, DIRECTOR, TAX POLICY CENTER

Mr. ALEXANDER. Thank you, Mr. Chairman.

My name is Donald Alexander and I am appearing here on behalf of the U.S. Chamber of Commerce with David Franasiak, director of the Tax Policy Center.

Mr. Chairman, the chamber has over 150,000 members who have less than 20 employees. What we are doing here today, sir, is representing small business, the majority of the chamber's membership, in connection with a bill that is a small business bill. Now this collegial process that you have heard about—there seems to be quite a divergence of view in the college with the three people that have testified thus far—small business was not a part of the college. It might have been well to have admitted a couple of small business people, despite their scores on the aptitude tests, because the purpose of the bill, as you have stated, Mr. Chairman, and as other have stated, is to eliminate traps for the unwary and simplify the law for small business that needs to have a simple and understandable law.

The suggestion of a toll charge that has been placed before you this morning by one of the witnesses, although not by the Treasury in connection with its effort to try to pass the bill immediately, would add bewildering complexity to the law to no useful purpose, because the toll charge is necessary only if one decides that the presence of accumulated earnings and profits in whatever amount, $1 or more in a corporation, requires different and for worse treatment for such corporations otherwise eligible to elect subchapter S, many of which have already elected subchapter S.

In 1980, the joint committee, with the Treasury's concurrence, recommended a complete elimination of the passive income test. In 1982, we find, for reasons that are inexplicable to those of us concerned about the effect of the bill on small business, a change in attitude. In reading the Treasury statement a few minutes ago, on pages 7 and 8 I think we find the reasons.

On page 8 of Treasury's statement, when they give an example of a small business that elects subchapter S and sells its assets and uses an alleged higher basis to reduce the tax on the sale, they point out that that small business person, having sold the operating assets and gone into passive assets, may commit the unpardonable sin of leaving the earnings of the company in the company until death. Death, in contemplation of saving taxes, is something we ought to do something about, Mr. Chairman. That is the problem.

If that is the problem, it is a problem that affects subchapter C corporations, all of them, as well as subchapter S. If the battle over carryover basis is to be fought, let's not make a casualty out of subchapter S corporations.

Many small businesses may have earnings and profits but they probably do not know it, and you are going to have a greater problem in the future as section 312(k), amended in 1981, piles up greater differences between the book and tax basis on one side and the basis for earnings and profits on the other. Despite what you have been told this morning, the retention of the present passive income test, 20 percent of gross receipts, would apply to an active business. Let me give you an example. Numerous examples could be given.

A corporation in the construction business receives steady rental income each year from renting certain of its facilities, but quite unsteady income from its construction activities, feast and famine, and now there is a lot of famine. That corporation finds to its surprise that its subchapter S election is terminated because it fails the present 202 test. It finds to its complete surprise that it has earnings and profits, although its balance sheet for regular tax purposes as well as lending purposes did not reveal any.

Under the proposal before you, the trap for the unwary would be retained. The chamber hopes that this trap will be eliminated and that Congress will act promptly and favorably on what is otherwise a pretty good bill. The restrictions on fringe benefits should be eliminated and the section 385 rules should not be adopted. They do not make sense in this context.

However, you cannot pass the bill the way it is, as the Treasury pointed out, because it has some provisions that conflict with, or are surely made redundant by the passage of the 1982 act, so you need to change the bill anyway. When you are changing the bill, let's make it a good, solid small business bill, usable by a small business for the purpose for which Congress intended it, without any tax leakage by reason of those corrections.

Thank you, Mr. Chairman.

The CHAIRMAN. Does this have the approval of the chamber's staff as well as the people who pay the dues at the chamber?

Mr. ALEXANDER. The chamber's staff is represented by Mr. Franasiak, and I believe that the chamber's staff and the dues-paying members of the chamber are solidly on the same side on this one.

The CHAIRMAN. That would be refreshing, yes.

Next.

STATEMENT OF JAMES D. McKEVITT, DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, ACCOMPANIED BY ABE SCHNEIER, TAX CONSULTANT

Mr. MCKEVITT. Mr. Chairman, going by your rules—I see you have a heavy day ahead of you—joining me is Mr. Abe Schneier from our office, and I would like to say briefly this:

No. 1, NFIB congratulates you and Senator Long. We think this is a bill that is much needed for subchapter S. In 1958, when the bill was passed, it was intended to hit toward and pick up small business. Even though approximately 19 percent of those who are incorporated are using subchapter S, only 5 percent of our membership of over a half million members are using subchapter S. I think one of the reasons why is the complexity that is contained therein, and this is a step in the right direction. We do thank you for that effort.

We do have two concerns, one of which I think has just been very articulately pointed out by Mr. Alexander, who I frankly think was one of the finest commissioners small business ever had at IRS. The other concern we have is dealing with debt equity.

At the present time the various small business groups are working with Senator Chafee, for example, and others, at IRS and particularly at Treasury, within the policy shop there, to come up with a simplified approach on debt equity or a definition, and I would hope that we would have the chance to give you some more input, you and the members of your staff, on both of these tests.

These are the two things that concern us the most. Other than that, we congratulate you, sir, and thank you for your efforts in making this much more simplistic.

The CHAIRMAN. Thank you, Mike.

Mr. Stults?

STATEMENT OF WALTER B. STULTS, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. STULTS. Mr. Chairman, I am Walter Stults with the National Association of SBIC's. We, too, congratulate you and Senator Long for introducing the bill. Our association strongly supports it and hopes that it will be passed by Congress before adjournment.

For many small businesses, subchapter S has been an extremely important feature of the code. We believe it encourages family members and other individuals to invest in new and growing businesses, contributing to the national policy goal of fostering capital formation.

I trust that the committee will come up with a good bill and not hold off and wait until Treasury comes up with some more ideas, as the Secretary suggested. Small business groups have been pushing for 20 years for many of the changes which are incorporated in S. 2350, and I do not know that we can wait another 20.

We have several points. All the witnesses from the business community, Mr. Alexander and Mr. McKevitt, have talked about the distributions. SBIC's by their very nature receive interest and dividend income. Therefore, they are passive. We believe the toll charge could be very hurtful to them. We have pushed for years for Congress to allow SBIC's as recipients of passive income to elect subchapter S.

We urge in the most dramatic way we can that you do not allow them to put section 385 rules as a barrier to subchapter S. Our organization represents venture capital companies that put equity capital, venture capital to work in independent small businesses. The four proposals that Treasury has come up with over the last 4 years on defining debt-equity are an absolute morass and would throw many, many of our best growth companies into the situation where they could no longer elect subchapter S treatment because of the type of instruments that they and their outside investors are into.

One final point: We believe that SBIC's should be allowed to be in the class of stockholders permitted to hold stock in a subchapter S corporation. Congress in 1958 set up the Small Business Investment Act and said we should invest in small businesses. In the same year Congress said subchapter S is good for small business. We have the anomaly now where an SBIC, as a public policy goal instrumentality, when it does invest in a small business it forces that small firm to lose its right to elect subchapter S. We feel, Mr. Chairman, that we should be allowed to be shareholders in a subchapter S corporation.

Thank you very much.

[The statements of Mr. Alexander, Mr. McKevitt, and Mr. Stults follow:]

STATEMENT
on
SUBCHAPTER S REVISION ACT OF 1982
before the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Donald C. Alexander
September 10, 1982

My name is Donald C. Alexander. I am a member of the Taxation Committee of the Chamber of Commerce of the United States, on whose behalf I am appearing today. I am a member of the law firm of Morgan, Lewis & Bockius, of Washington, D.C. I am accompanied today by David E. Franasiak, Director of the Chamber's Tax Policy Center. On behalf of the Chamber of Commerce's over 256,000 business, trade association, and local and state chamber members, we welcome the opportunity to support the broad objectives of S. 2350, the Subchapter S Revision Act of 1982.

Subchapter S of the Internal Revenue Code was enacted to minimize the effect of Federal income taxes on choices of form of business organizations and to permit the incorporation and operation of small businesses without the incidence of income taxation at both the corporate and shareholder levels. The Committee on Finance specifically invited comment on the proper treatment of regular corporations electing Subchapter S. This includes the issues of whether the passive income limitation under current law should be retained and whether there should be a "toll charge" or similar exaction upon the conversion of a regular corporation to Subchapter S status. Comment is also requested on the potential application of the section 385 debt-equity regulations to Subchapter S corporations.

Introduction and Summary

The Chamber commends Chairman Dole and the Committee for their effort to simplify and improve Subchapter S for small businesses. Over 90% of our business members employ fewer than 500 people and over 60% employ fewer than 20 people. These small businesses would greatly benefit from improved Subchapter S provisions. S. 2350 would make substantial headway toward achieving that goal. By easing the eligibility rules for Subchapter S election, eliminating certain traps, and improving the rules for passthrough of losses and various types of income, S. 2350 will have a broad beneficial effect on small business.

However, in its present form, the bill would not remove the passive income test for companies with accumulated earnings and profits making a Subchapter S election, thus continuing one of the most troublesome provisions in present Subchapter S. This serves no real revenue purpose and inhibits the use of Subchapter S by the small businesses it was intended to serve. The passive income test should be eliminated entirely. Furthermore, no "toll charge" or other penalty should be imposed on regular corporations which make a Subchapter S election. Permitting a business to elect out of the toll charge at the cost of continued subjection to the passive income test is no answer.

I. Passive Income Test

Under S. 2350, the passive income test is eliminated except for companies which make the Subchapter S election when they have some earnings and profits accumulated from prior years. In order to evaluate this issue properly, it is first necessary to review the passive income test and the problems that it has created in the past and will continue to create in the future if retained to any extent. The second issue is to determine what purpose will be served by the retention of the passive income test and whether these anticipated benefits outweigh the detriments created by its retention.

A. Present Law.

Under the passive income test of present Section 1372(e)(5), a Subchapter S election is terminated if more than 20% of the gross receipts of the electing corporation are rents, royalties, interest, dividends, annuities and sales or exchanges of stock or securities. This restriction is a trap for the unwary, has generated much litigation, and no longer serves any revenue purpose.

Many controversies have arisen about whether interest, rents, or other types of income earned in the active conduct of a trade or business are bad "passive" income or good "active" income.[1/] Decided cases are, of course, only the tip of the iceberg. Numerous inadvertent disqualifications have

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[1/] See, for example, Marshall v. Commissioner, 510 F.2d 259 (10th Cir. 1975) aff'g 50 T.C. 242 (1973) (interest received by a corporation actively engaged in small loan business is passive income); and Zychinski v. Commissioner, 506 F.2d 637 (8th Cir. 1974), aff'g 60 T.C. 950 (1973) (gain on sale of securities by securities dealer actively engaged in trading stocks is passive income).

occurred, and the uncertainty of classification of income (e.g., "active" rents) and whether business factors and economic conditions may cause "passive" income to increase beyond the permissible level have had a serious adverse effect upon the use of Subchapter S by small businesses which it was intended to benefit. Circumstances beyond the control of taxpayers frequently result in terminations. For example, a Subchapter S corporation engaged in building homes leased its idle equipment during poor economic times in order to defray expenses. The leasing income constituted its only income in one year, and its election was terminated.

B. Proposed Changes.

The staff of the Joint Committee on Taxation recommended in their report on Subchapter S of April 30, 1980 that the passive income test be eliminated completely in order to reduce uncertainty as to whether certain types of income were covered by the limitation, to reduce litigation and to prevent retroactive termination of elections. The Treasury agreed.

The removal of the differential between the top individual income tax rates upon investment income and those upon earned income eliminates any reason to use Subchapter S to try to convert investment income into earned income. Moreover, the personal holding company provisions would not be vitiated by removal of the passive income test because the income of an electing corporation is taxed directly to its shareholders.

S. 2350 deletes the passive income test for S corporations with no accumulated earnings but retains the test, unaltered, for all other S corporations. Thus, the trap under present law would be continued for all corporations with retained earnings accumulated during the period of operation under Subchapter C. Corporations exempted from the harsh test would be those newly incorporated under Subchapter S and those which either had no earnings or rid themselves of their earnings from operations prior to the Subchapter S election.

Many small corporations considering a Subchapter S election will have accumulated earnings but will not know it. The computation of earnings and profits is very difficult for even the most sophisticated corporation with the best records and advice; the problem is compounded for a small corporation which cannot afford such luxuries. Also, many owners of small corporations believe, erroneously, that earned surplus on their books equals earnings and profits for tax purposes. This is not the case, and the 1981 Economic Recovery Tax Act (ERTA) compounds the problem. New Code Section 312(k), added by ERTA, and changed by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), requires a far different computation of capital cost allowances for earnings and profits purposes than that permitted for tax computation purposes. The existence of unknown accumulated earnings has proved to be a trap under Section 333 of the Code. This trap should not be extended to Subchapter S unless there are compelling reasons for its extension.

Moreover, an existing corporation believing that it has significant earnings accumulated while operating under Subchapter C of the Internal Revenue Code (which deals with taxation of corporations in general) would be faced with a dilemma. Should it distribute earnings, thereby reducing its resources in an effort to purge itself, or run the risk of a termination of its Subchapter S election by reason of its inability to control the exact mix of future gross receipts? Furthermore, if it decided to rid itself of its earnings but distributed too little, it would avoid neither the present detriment nor the future danger.

It appears that retention of the passive income test may stem from a concern that its elimination might lead to use of an S corporation to avoid tax to its shareholders on previously-accumulated earnings. We do not believe that this concern has any foundation. In reviewing this issue, one must keep in mind the fact that the accumulated earnings have already been subjected to tax at the corporate level.

Under present law, the shareholders of both an S and a C corporation are subject to tax on dividends paid from accumulated earnings. Under S. 2350, these rules remain in effect. If such accumulated earnings are invested by a C corporation, the current income thus derived is subject to tax at corporate rates rather than the generally higher individual rates. In the case of an S corporation, such income is taxed to the shareholders at individual rates. The same result would follow under the bill.

The restoration of stepped-up basis in the event of death has been described as a potential for tax avoidance in the case of a C corporation with accumulated earnings electing Subchapter S treatment. When in, 1980, Congress revised its 1976 action and restored stepped-up basis, it decided that corporate earnings realized by the shareholders may be freed of tax at the shareholder level if shares pass through an estate and the heirs sell or liquidate the corporation. Surely it was not intended to limit the benefit of stepped-up basis to Subchapter C corporations.

Why should a restriction be placed in Subchapter S to solve a problem (if it is a problem) created by the restoration of stepped-up basis? In this context the only advantage of electing Subchapter S status is to obtain pass-through treatment of interim corporate earnings awaiting the death of the shareholder. However, this ephemeral advantage is at odds with the purported motive for the election; the longer the "interim benefit", the longer the delay until death completes the tax plan. Relieving undistributed corporate earnings from shareholder tax is a function of Code Section 1014, not of Subchapter S. If the major concern centers on stepped-up basis, that issue should be addressed directly, not in the context of Subchapter S simplification.

In short, there is no justification for perpetuating the confusion and uncertainty caused by the passive income test. The intent of the bill is to simplify the operation of S corporations and ease the eligibility rules as to obtaining and preserving S corporation status. Elimination of the passive income test would greatly further these goals and would not promote tax avoidance.

II. Toll Charge

Comment has been requested on the tax treatment of the election of Subchapter S status by Subchapter C corporations with accumulated earnings and profits. It has been proposed that some toll charge be imposed if the corporation making the election has accumulated earnings. A "two track" approach has been suggested. The shareholders of an existing Subchapter C corporation with accumulated earnings and profits, wishing to convert to Subchapter S, could elect to have a toll charge apply to their respective shares of accumulated earnings and profits. Shareholders would pay tax at capital gains rates over a five-year period. The effect of this constructive liquidation would be to purge the corporation of its accumulated earnings and profits, and make the corporation eligible for all of the new rules of S. 2350. Subchapter C corporations whose shareholders chose not to make this special election, but still wished to convert to Subchapter S status, would be subject to the passive income test in its current rigor, and perhaps to separate rules covering distributions out of accumulated earnings.

Under this "two track" approach, the potential for tax abuse, if the restrictions on the election are not strict enough, or for imposition, in the guise of simplification, of a whole new set of rules of bewildering complexity to prevent abuses, is readily apparent. A tax avoidance scheme of great potential could easily be created. Permitting electing shareholders of existing Subchapter C corporations to withdraw accumulated earnings and profits at capital gains rates provides the opportunity for a recurring bail-out of earnings. Under one proposal, a corporation and its shareholders could elect to bail out Subchapter C earnings at capital gains rates, pay the tax over five years, revert to Subchapter C and accumulate income for five years, and then repeat the bail-out process under Subchapter S. It is unlikely that many well-advised Subchapter C corporate shareholders would not take advantage of such a prime tax avoidance opportunity, particularly if the alternative, "second track" option, of not making the special election would subject the corporation to an entirely new set of complicated rules and cause any distributions out of accumulated earnings to be fully taxed.

A toll charge is premised upon the incorrect assumption that converting from Subchapter C to Subchapter S is identical to a liquidation. It is not.

Imposing a toll charge on the conversion of a Subchapter C corporation to a Subchapter S status is overkill. Despite the fact that the bill would treat Subchapter S corporations more like partnerships, a C corporation converting to Subchapter S does not, in fact or in effect, liquidate. The conversion is in no way equivalent to liquidation because (1) basis is not stepped-up but instead carries over, (2) earnings and profits produce the same dividend consequences as if the corporation had continued in Subchapter C status.

S. 2350 wisely imposes no toll charge upon the act of electing. A mandatory charge would be a long step backward toward reducing the utility of Subchapter S. The complexities and conditions required to protect the revenues against the use of an elective toll charge to effect a bailout of earnings would add substantially to the complexity of the Code and to the revenues of tax practitioners, but do little for small business. Without stringent restrictions and conditions, an elective toll charge would create a new loophole of enormous proportions. Moreover, an elective toll charge is not needed if, as we urge, the passive income test is removed for all corporations.

The fact that the character and tax treatment of future revenues from particular sources (e.g., natural resources) would be passed through to the stockholders of the Subchapter S corporation does not require the imposition of the wrong tax at the wrong time upon the wrong base. These considerations go only to the treatment of future revenues; the existence of past earnings is irrelevant.

III. Section 385

Comment has also been requested on application of the Section 385 debt-equity rules to Subchapter S. We agree with many of those who have addressed this issue that Section 385 should not be applicable to Subchapter S. Imposition of Section 385 would add an additional set of complicated rules at a time when efforts are being made to simplify Subchapter S. Moreover, the potential abuses of "thin capitalization", designed to avoid tax at the corporate level by designating as debt what is in reality equity, is not readily evident in the context of Subchapter S since there is no corporate level tax, and all earnings are taxed directly to shareholders.[2]

IV. Deferred Compensation and Fringe Benefits

The TEFRA contains a number of provisions designed to equalize the tax treatment of corporate and non-corporate pension plans. Generally, the distinctions between the qualified pension plans of corporations and those of self-employed persons (H.R. 10 plans) are being eliminated, either through repeal of special rules applicable only to H.R. 10 plans, or extension of certain rules to all qualified plans. These changes are applicable also to plans of Subchapter S corporations, thus equalizing the treatment of H.R. 10 plans and Subchapter S plans.

Section 1372(a) of S. 2350 provides that Subchapter S shareholders owning in excess of 10% of the company's stock will be treated like owner-employees for purposes of qualified deferred compensation. The purpose of this section is to treat any pension or profit-sharing plan of a Subchapter S corporation like an H.R. 10 plan. The changes enacted by the pension provisions of the new tax bill accomplish this purpose. Accordingly, Section 1372(a) of S. 2350 should be deleted.

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[2] See Portage Plastics Company v. United States, 486 F.2d 632 (7th Cir. 1973).

Section 1372(c) of the bill imposes partnership rules for fringe benefits on all Subchapter S shareholders owning more than 2% of the company's stock. We believe such action is unnecessarily restrictive. Furthermore, the 1982 Tax Act changed the rules governing two significant fringe benefits, and further changes are neither needed nor advisable. Section 244 of TEFRA imposed new non-discrimination rules upon employer-provided group life insurance. Section 239 of TEFRA amended Code Section 101 to extend the death benefit exclusion for lump-sum distributions to the self-employed. These actions remove the need for further Congressional action as to these fringe benefits, and we submit that the Congressional policy evidenced by TEFRA should not be reversed or undermined as to Subchapter S corporations.

V. Termination Provisions

Present law limits the making of a voluntary revocation of an election. Small businessmen contemplating a Subchapter S election who do not have resources for expert tax advice on the benefits and detriments of Subchapter S frequently discover within the first year of the election that the decision to elect was ill-considered. Current law defers the effectiveness of a voluntary revocation of an election unless made during the first month of a year, but provides a means to terminate the election retroactively if one deliberately undertakes to violate one or more of the Subchapter S eligibility requirements.

S. 2350 modifies and improves current law by permitting a revocation to be made within the 15th day of the third month for any taxable year. However, revocations after that date are effective only for the following taxable year. We support the concept of expanding the opportunity to make a voluntary revocation and believe that electing shareholders should be permitted to revoke an election by the due date for the return for the first taxable year of operation under Subchapter S. Small businessmen should not be penalized because they have been unable to foresee all the consequences of Subchapter S. Moreover, retention of the five-year ban on subsequent Subchapter S elections should prevent abuse.

VI. Conclusion

We support the broad objectives of S. 2350. Our recommendations are submitted in furtherance of these objectives. We would be glad to work with the Committee and staff on the issues discussed above.

NFIB National Federation of
Independent Business

STATEMENT OF

JAMES D. "MIKE" MCKEVITT
DIRECTOR OF FEDERAL LEGISLATION

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

BEFORE: Senate Finance Committee

SUBJECT: Subchapter S Revision Act of 1982

DATE: September 10, 1982

Good morning, Mr. Chairman:

I am Mike McKevitt, Director of Federal Legislation for the National Federation of Independent Business (NFIB). Accompanying me today is Abe Schneier, Tax Consultant for NFIB. On behalf of the 505,000 members of the National Federation of Independent Business (NFIB), we appreciate this opportunity to comment on S. 2350, the Subchapter S Revision Act of 1982. The provisions of Subchapter S in the tax code are widely misunderstood by the average small business owner and in a broad sense have failed to accomplish the original goals. The original intent of Subchapter S in 1958 was to "eliminate the influence of the Federal income tax in the selection of the form of business organization which may be most desirable under the circumstances".[1] This was to be accomplished by establishing a corporation which would permit partnership reporting on items of income.

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[1] 83rd Congress, 2d Sess., S.Rep.No.1622 (1959)

While simple in concept, the designation of Subchapter S status involved many strict and complex rules, violation of which could cause termination of Subchapter S status for the business. It is interesting to note that in 1976, there were approximately 400,000 corporations who had elected Subchapter S status, or approximately 19% of all corporations. Recent studies of small business patterns among NFIB members show that only 5% have elected Subchapter S status. We believe that regulartory complexity has prevented many operating small businesses from electing Subchapter S status.

We congratulate Chairman Dole and Senator Long on their cosponsorship of S. 2350, because this legislation revises and simplifies many of the rules which in the past have prevented wide small business utilization of Subchapter S. We would, however, like to comment on two problem areas with your proposal which have been brought to our attention by our membership.

Passive Limitation Test and Earnings and Profits

The Joint Tax Committee, in its 1980 report on Simplification of Tax Rules Relating to Subchapter S Corporations, recommended elimination of the passive income limitation test. The recommendation was based on two facts: 1) subsequent amendments to the tax code prohibited those activities which the passive income limitations were originally designed to protect against; and 2) the passive income limitations had caused many litigation problems, as passive income was never clearly defined. In fact, the passive income test became a trap for the Subchapter S owner who may not have been aware that these rules existed, sometimes causing inadvertant termination of the Subchapter S election. Elimination of the passive income limits has been recommended in S. 2350, but only if the firm has no accumulated earnings and profits.

While in most areas the Internal Revenue Code and its accompanying regulations are overly descriptive in defining tax terminology, there is no clear definition of "earnings and profits." Nor is there a definitional counterpart for earnings and profits in the field of corporation law.

The computation of earnings and profits is usually very complex for a practitioner. In many cases earnings and profits are misunderstood by the business owner, who would most likely confuse earnings and profits with financial accounting profits.

The concern appears to be that a corporation electing Subchapter S status would have an advantage in its ability to earn passive income from earnings and profits accumulated prior to its electing Subchapter S status. The bill therefore proposes that all taxable income and accumulated earnings and profits be distributed or the firm will be subject to the passive income limitation test.

Unless the accumulated earnings and profits are invested in non-taxable municipal bonds, the earnings are deemed distributed to the shareholder under Subchapter S rules and, therefore, are taxable at individual rates. All that would be accomplished by providing this new earnings and profits test in the absence of clear statutory guidance is a new trap for the unwary small business owner who can

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get whipsawed between two tests which have nothing to do with tax avoidance. Indeed, it appears that the interests of supporting an active business are being submerged relative to the compliance problem with sophisticated tax planners. In the average small business, all accumulated earnings, no matter how defined, are generally utilized by the firm in inventory, payroll or other business needs. Any accumulated profits will either help the business defer borrowing or eventually be used in purchases of capital assets. Using large amounts of earnings to gain passive investment income is the exception, not the rule, for a small business.

It appears that the very benefit given under Subchapter S is the cause for so much concern. What, then, is the motivation for electing Subchapter S status? Simply, it is to legally minimize a business' tax burden, or to promote capital retention. It is not a method of liquidating an active business into a tax shelter. The need to retain earnings for use in the business is vital in financing inventory and in capital accumulation. For many firms, utilization of Subchapter S status could result in a reduction of tax burdens and help new expansion by creating new capital.

We would recommend that the passive income limits not be held hostage to an earnings and profits test. The result would be an unnecessary complication which would prevent utilization of Subchapter S by those for whom the benefits are intended, i.e. active operating small businesses. That accumulated earnings and profits prior to a Subchapter S election might constitute an advantage is no more an advantage than the accumulation of retained earnings for a regular corporation.

Debt-Equity Problems (Section 385 IRC)

The IRS has been struggling for over twelve years to issue regulations defining when a debt issue is to be treated as equity. The problem is an acute one for Subchapter S, since only one issue of stock is permitted under a Subchapter S election. If debt were to be defined for tax purposes as equity, that could terminate the election.

Recently the Treasury Department announced an additional postponement of the effective date of debt-equity regulations, from July 1, 1982, to April 1, 1983. This additional postponement occurred in part because of the concerns raised by small business representatives over the impact of the regulations as proposed.

Subchapter S has not yet been addressed within the regulations by Treasury because of the grave implications for Subchapter S. The practical realities of strictly enforcing Treasury's proposed debt-equity standards for Subchapter S could be the elimination of needed capital from private investors and other sources. Moreover, the need for debt equity rules is predicated upon the problem of this capitalization of small corporations. Since a Subchapter S corporation is currently taxed on all earnings, the issue loses its significance.

We would request that this problem be given further study and that any alternatives be explored after the Department of the Treasury regulations for regular corporations have been finalized.

We should remain cognizant of the purposes of Subchapter S, i.e. simplification and the promotion of small firms' growth by not restricting capital. Any proposals should be designed to work within these contexts.

Thank you, Mr. Chairman.

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STATEMENT OF

WALTER B. STULTS

Before the

SENATE FINANCE COMMITTEE

September 10, 1982

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

Thank you for giving me this opportunity to testify on The Subchapter S Revision Act of 1982 (S.2350).

I am Walter B. Stults, President of the National Association of Small Business Investment Companies, a trade association which represents the overwhelming majority of all Small Business Investment Companies (SBICs) and Minority Enterprise Small Business Investment Companies (MESBICs).

As you know, SBICs are privately organized, privately capitalized and privately managed venture capital firms which provide equity capital, long-term loans, and management assistance to new and growing small business concerns. SBICs are licensed under the Small Business Investment Act of 1958 and regulated by the Small Business Administration.

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NASBIC strongly supports S.2350 and hopes that it will be passed by Congress before adjournment this year. For many small businesses, Subchapter S has been an extremely important feature of the Internal Revenue Code. The option to elect Sub S tax treatment permits thousands of such concerns to gain the advantages which come from incorporation without subjecting them immediately to corporate taxes. We believe Sub S encourages family members and other individuals to invest in new and growing businesses, thus contributing to the national policy goal of fostering capital formation.

For a number of years, NASBIC and a number of other small business organizations have urged Treasury and the Congress to amend Subchapter S to expand its usefulness. The bill before you, S.2350, achieves that goal in several important ways, so its enactment would mark a significant step forward.

Our Association believes two additional amendments would make the legislation even more valuable. Both are relatively minor and should be non-controversial.

NASBIC's first amendment to S.2350 would amend Section 1361 to permit SBICs to own stock in a Subchapter S corporation. We now have this anomalous situation: Congress passed the SBIC Act in 1958 to encourage outside investment in new and growing businesses. Also in 1958, Congress authorized Subchapter S tax treatment, largely for the same reason. BUT, if an SBIC invests in a closely-held business, it forces that concern to give up its right to be taxed under Subchapter S.

Our Association has long advocated a change in Subchapter S to permit SBICs to be shareholders in Sub S corporations. Our stand is not self-serving, because it would redound to the benefit of the small business, not to the profitability of the SBIC. Since most SBICs seek capital gains, not ordinary income, they have little incentive to invest in Sub S companies. On the other hand, SBICs prosper only when their portfolio companies succeed, so we support all measures which will assist small businesses.

Our first amendment, then, would permit SBICs to become shareholders in Subchapter S corporations.

Our second proposal deals with the "passive income" test. We heartily support the pending proposal to permit election even where more than 20% of the electing corporation's income comes from passive income. S.2350 would enable newly-licensed SBICs and older SBICs which do not have any accumulated earnings and profits to elect under Subchapter S.

On the other hand, for other existing SBICs, a distribution of accumulated earnings to their shareholders in order to qualify for the election would result in harsh tax consequences for the shareholders, since the distributions would be taxable to them at ordinary income rates.

We strongly urge the Committee to amend this section of the pending bill to permit a one-time distribution of accumulated earnings and profits to the corporation's shareholders, with such distributions taxable to the holders at capital gains rates, rather than at ordinary income levels.

We are grateful to the Committee for exploring the entire Subchapter S question. Subject to the two minor amendments I have mentioned, NASBIC wholeheartedly supports S.2350.

Thank you.

The CHAIRMAN. Mr. Danforth?

Senator DANFORTH. No questions, Mr. Chairman.

The CHAIRMAN. I believe that I have indicated to other witnesses, we understand that these are areas that ought to be addressed and we certainly have confidence in the statements made by the witnesses before this panel. We may not be able to accommodate every concern. I am also fearful that we do not want to add any complexity to the system. I do not understand the toll charge totally, but enough to be concerned about it.

We hope that you will be available to work with our staff and the joint committee, the Treasury, the AICPA, and the bar association because we want to make certain that there is small business input into the process.

Mr. STULTS. We appreciate that, Mr. Chairman.

The CHAIRMAN. The next panel is Lanier Frantz, vice president of Graham-White Manufacturing Co., and Howard Lyman.

Mr. Frantz.

STATEMENT OF LANIER FRANTZ, VICE PRESIDENT, GRAHAM-WHITE MANUFACTURING CO., SALEM, VA.

Mr. FRANTZ. Mr. Chairman, my name is Lanier Frantz. I am vice president of the Graham-White Manufacturing Co., of Salem, Va. We manufacture various types of equipment used by the railroad and trucking industries.

In connection with our manufacturing processes, Graham-White has been recognized as one of the most efficient specialty foundries in the United States. Our company elected subchapter S status shortly after the present rules were added to the code in 1958. As a result, Graham-White is one of the oldest subchapter S corporations in the country.

As an existing subchapter S corporation, one of about 500,000, we have not been enthusiastic about the legislation because it does not help us and, indeed, with respect to our life, health, and accident plans, it seriously hurts us. The principal backers of the bill are real estate, natural resource, and professional groups. We do not begrudge these groups the benefits they see in the bill; we simply do not want to fund these benefits by sacrificing one real existing benefit; namely, our statutory fringe benefits that presently exist for profit manufacturing companies that operate under subchapter S.

We have been subchapter S for about 17 years. It took a long time to learn the present rules and, if we have to, we will figure out the new ones. For a manufacturing company like ours there are only three benefits associated with subchapter S status: Flow through of income and losses, limitation of shareholders' liability, and statutory fringe benefits. Mature companies try not to have losses. The solution to the liability problem is to bind the corporation as a regular corporation or by purchasing insurance. The foremost benefit from our standpoint is the statutory fringe benefit, that is, the exclusion from income of the amounts paid for health and accident coverage, the limited exclusion of group term life insurance, and so forth. It is these benefits that the bill would eliminate.

Most subchapter S corporations are relatively small, and many depend on good employee relations. Most, like our company, do not have problems with antidiscrimination rules since all employees, whether or not shareholders, are benefited under the various plans. The Tax Equity and Fiscal Responsibility Act of 1982 touched upon two of these fringe benefits. It applied the antidiscrimination rule to group life insurance and it extended the death benefit exclusion to lump-sum distributions to self-employed individuals.

We submit that whatever else the Subchapter S Revision Act does, it should not eliminate statutory fringe benefits. This point is supported, I believe, by all of the groups, including the U.S. Chamber, the National Association of Manufacturers, and the American Institute of Public Accountants. If for some reason the committee wants to retain the objectionable provisions and the remnants of the passive income test, which we and others view as nonsensical, at the very minimum presently existing subchapter S corporations that continue to meet the old passive income test should be permitted to continue with their statutory fringe benefits, such as group life and health and accident plans.

I would add the following random points for the committee's consideration: First, a passive income test to be triggered by the existence of an earnings and profits account is a bad idea. As a matter of fact, anything that requires an existing subchapter S corporation to compute its earnings and profits account is a bad idea, since most of them do not know how to compute or to reconstruct such an account.

Second, today subchapter S corporations can have a domestic internal sales corporation, or a foreign corporation, just like a regular corporation. The bill reverses the present law. Given that the country is trying to promote exports by smaller companies, this is one of the most puzzling proposals of the bill. Graham-White does not have a DISC or a foreign subsidiary today but we might like or need one in the future.

Third, the debt equity rules in section 385 and the proposed regulations thereunder should not be applied to subchapter S corporations. They are too complex and are unnecessary for a passthrough entity like a subchapter S.

Finally, the rollover issue, or what to do with the earnings and profits account of an existing, regular corporation that elects subchapter S status, is none of our business and we will not comment on it.

Mr. Chairman, this bill has received very little press and most of it has simply mentioned that it would be a simplification of additional stockholders, passive income, and so forth. We do not have an association as such, we have subchapter S corporations. We are not readily identified as a group. We have no lobby as such here today. I submit that if this bill is passed in the present form, there is going to be a great concern and a great undue burden to many existing and mature corporations that are operating under this existing subchapter S rule.

Thank you very much for the opportunity to be here today.

The CHAIRMAN. I would ask the staff to particularly note your concerns. There may be some way to deal with those, and there may be others who have a similar problem.

Mr. Lyman?

Senator BAUCUS. Mr. Chairman, if you might yield, the next witness as you have just indicated is Howard Lyman from Great Falls, Mont. Mr. Lyman is a close friend of mine. He is an articulate, aggressive small businessman from the State of Montana.

As you may know, Montana is known as the Big Sky State. Howard Lyman comes very much from the Big Sky area of Montana, in that the fellow who coined the phrase Big Sky, the novelist named A. B. Guthrie, has his ranch not too far away from Mr. Lyman's ranch.

Mr. Lyman is involved in agriculture, as well as a small businessman, and I am very honored to have him here. Thank you, Howard, for coming to present your views.

I might say, Mr. Chairman, too, I am going to commend you and Senator Long for cosponsoring and pushing this bill. It is an area in the code that has to be simplified and, as you know, you have our strong support.

The CHAIRMAN. Thank you.

Mr. Lyman.

STATEMENT OF HOWARD LYMAN, GREAT FALLS, MONT.

Mr. LYMAN. Mr. Chairman, I am Howard Lyman, a farmer-rancher, feed lot operator-developer from Great Falls, Mont. I would like to testify in support of S. 2350.

I, as a businessman and a small businessman, have a small business corporation, subchapter S. I was also involved in a family corporation where we had a death, and many of the problems that are addressed in this bill happened within our corporation.

Just in passing and shortly, I would like to say that the passive income portion of the bill now is too restrictive. We need some flexibility to deal with the businesses as they change out in the field. We also got into a problem when we talked about an increase in shareholders when we had a death in the family, because stock was passed from one stockholder to many. The election to eliminate the corporation is a very touchy subject when you end up with a death in the family and you get stock passed to people that have had no problems with it or no involvement in the past in the operation of the corporation, and they immediately become stockholders, so I think that there is some work that needs to be addressed in that area and I think that S. 2350 addresses that. I think it is a tremendous improvement.

One of the other problems that is now present that I think S. 2350 deals with is the determination by all, that when you end up with new stockholders not familiar with what has happened, to get total agreement by all at a time of stress like that is almost impossible. I think that this bill addresses that and I think it is a tremendous move forward.

One of the other things, and probably the best part of the bill, is the retroactive revocation of the subchapter S election. Small business today does not have the sophisticated accounting procedures available to know exactly where they are at all times, and when you can go back in time with the retroactive revocation of the subchapter S agreement, I believe that that is a tremendous improvement for small business.

I would really commend you for your leadership in this area, in bringing this bill forward, because it is definitely what we need out in the field to make it more usable for my kind of business.

I thank you, Mr. Chairman.

[The statement of Mr. Frantz follows:]

PREPARED STATEMENT OF GRAHAM-WHITE MANUFACTURING CO. ON THE SUBCHAPTER S REVISION ACT OF 1982

Mr. Chairman, my name is Lanier Frantz. I am Vice President of Graham-White Manufacturing Company in Salem, Virginia. Graham-White is a manufacturer of various types of equipment and components used in the transportation industry. In connection with its production efforts, Graham-White has been recognized as one of the best and most efficient specialty foundries in the United States. My company elected Subchapter S status shortly after the present rules were added to the Internal Revenue Code in 1958. Consequently, Graham-White is one of the oldest and largest Subchapter S companies in the country.

My testimony this morning deals with that part of S. 2350 that disallows deductions to Subchapter S corporations for amounts expended for owner-employee fringe benefits. This disallowance provision is accomplished by treating, for purposes of employee fringe benefits, a Subchapter S corporation as a partnership and any 2% shareholder of the corporation as a partner. Thus, inasmuch as partners of a partnership have been denied the status of employees for other tax purposes, the result of this characterization is the denial to the corporation of deductions for so-called statutory fringe benefits which would otherwise be allowable with respect to employees who are not shareholders. This disallowance for statutory fringe benefits includes premiums paid for accident and health insurance plans and group life insurance. However, since the term "fringe benefits" is undefined in this bill or elsewhere in the Code, the scope of the provision is somewhat unclear.

Last month, Congress and this Committee considered the issue of fringe benefits for owner-employees of corporations in connection with the Tax Equity and Fiscal Responsibility Act of 1982. In the Act, new non-discrimination rules were imposed upon employers paying group life insurance premiums for certain key employees. Rules which permit deductions to corporations, but not to partnerships, for amounts paid with respect to accident and health insurance plans for owner-employees were left unchanged.

Inasmuch as the allowance for these deductions to closely-held corporations has already been considered in the 1982 Act, it seems inappropriate for this bill now to disallow deductions for such important fringe benefits to owner-employees of Subchapter S corporations. Such a disallowance would discourage the creation of new fringe benefit plans and encourage the discontinuance of those plans presently in place. Thus, employees without stock interests stand only to lose fringe benefits; and it is precisely these employees who depend far more upon such fringe benefits programs than employees who own stock.

In short, Graham-White endorses the position of the U.S. Chamber of Commerce, the AICPA, and other groups that the statutory fringe benefit rule is unwarranted and should be dropped. Alternatively, at least for existing Subchapter S corporations that continue to meet the old passive income tests—if the remnants of these tests are not dropped from the bill, the statutory fringe benefit rule should not apply.

Thank you for the opportunity to testify, and we welcome an opportunity to work with you to resolve this problem.

The CHAIRMAN. Thank you, Mr. Lyman.

I would just say that we are going to try to work it out, and hopefully we can address your concerns, too, Mr. Frantz, and the others that have been expressed here this morning. I have instructed the staff to work with the witnesses and take careful note of what has been stated here because some of you are not accessible. Some of you do not live here but we can keep in touch by telephone, and of course through Senator Baucus, Senator Byrd of Virginia, and others.

We appreciate Mr. Lyman's testimony. Are there any questions?

Senator BAUCUS. Not from me, thank you.

The CHAIRMAN. Jack.

Senator DANFORTH. No.

The CHAIRMAN. Thank you very much.

[Whereupon, at 11:20 a.m., the committee recessed, to reconvene immediately thereafter to discuss certain committee business.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

ARTHUR ANDERSEN & CO

Testimony of Richard L. Thomas
Summary of Significant Points

A. Areas on Which Comments are Requested by Sponsors of S 2350

1. Tax Impact of an S Corporation Election on Shareholders

The sponsors of the proposed legislation are concerned that an S corporation election may present a tax avoidance opportunity to be corrected by a tax at the time of the election. This is not consistent with the intent of Subchapter S and would automatically eliminate Subchapter S as an option for many qualified corporations.

2. Debt/Equity Regulations and Single Class of Stock

The Section 385 regulations should not be applied to shareholder debt of S corporations in a manner that would terminate the election. The debt/equity relationship is not a major problem.

3. Foreign Gross Receipts Limitation

The foreign gross receipts limitation should be eliminated. There is no practical reason for it; tax abuse possibilities are covered by Subchapter N.

B. Specific Provisions of the Bill

1. Ineligible Corporations - Section 1361(b)(2)

An S corporation should be permitted to own a DISC or a foreign subsidiary. There is little or no potential for tax abuse.

2. Filing of Shareholder Consents - Section 1362(b)(2)(B)(ii)

Extensions of time to file consents by shareholders of an electing corporation should be allowed under certain circumstances without deferring the effective date of the S corporation election until the following taxable year.

3. Passive Investment Income Limitation - Section 1362(d)(3)

The passive investment income limitation should be eliminated. Specific provisions should be drafted to cover a corporation selling operating assets and remaining in existence as an investment vehicle.

4. Inadvertent Termination - Section 1362(f)

The proposal for continuation of the election following an inadvertent termination is too uncertain. The provisions should be more specific.

5. Basis in Shareholders' Investment - Section 1366(d)(1)(B)

Corporate debt guaranteed by shareholders under bona fide requirements of the lender should be included in basis for the limitation on deduction of losses.

6. Distributions and Adjustments to Basis - Sections 1367 and 1368

The Bill is not clear on the timing of basis adjustments with respect to distributions. The language should be made specific to prevent misunderstanding.

7. Foreign Loss Recapture - Section 1373(b)

The foreign loss recapture rule is too harsh. There should be no recapture upon making an S corporation election.

8. Changes in Stock Ownership - Section 1378(c)(1)

The provisions restricting changes of stock ownership as a condition to continuing use of a fiscal year should have a time measurement limit of three years.

9. Newly Owned Stock - Section 1378(c)(2) and (3)

The change of ownership rules should not apply to certain redemptions and family gifts.

10. Distribution of Previously Taxed Income - Section 1379(c)(1)

The Bill places a new time limit on distributions of Previously Taxed Income from preenactment taxable years. This seems unreasonable and is probably unintended.

11. Effect of Election on Depletion - Bill Section 3(a)

Treating an election as a transfer of proven oil and gas properties, thus denying future percentage depletion deductions to the shareholders, strikes against the basic rule exempting a mere change in business form with no change in ownership ratios from the definition of a transfer.

12. Payments to Shareholders - Bill Section 3(g)(2)

The limitation should apply only to a 10% or greater shareholder interest for S corporations other than certain personal service corporations.

My name is Richard L. Thomas. I am a tax partner, Head of the Subchapter S Tax Specialty Team, for Arthur Andersen & Co. We welcome the opportunity to testify before this Committee today on the subject of S 2350, the "Subchapter S Revision Act of 1982." Our testimony is consistent with that submitted at the Public Hearing on H.R. 6055 held on June 14, 1982, by the House Subcommittee on Select Revenue Measures, and supplemental comments submitted after the hearing.

The Arthur Andersen world wide organization conducts an international accounting practice. We have many clients that will be affected by the proposals; however, we do not represent them in this testimony and the views expressed are those of the Firm itself.

There are often non-tax legal and business considerations that dictate the corporate form of doing business even though a corporation is least desirable for Federal income tax purposes. The original intent of Subchapter S, when enacted in 1958, was to permit taxpayers to select a form of business entity with reasonable independence of Federal income tax consequences. The provisions of Subchapter S and subsequent amendments have gone part way toward achieving that goal. S 2350 is a giant step, however, and we are pleased with the overall intent of the Bill and support early consideration and passage.

There are a number of areas where we believe clarification and improvements should be made, and will address our comments accordingly. Major improvements to Subchapter S are very important to the thousands of existing Subchapter S corporations and the many more closely held corporations and yet to be formed businesses for which Subchapter S will be desirable. The improvements are not so important, however, that legislation should be enacted without thorough consideration of the real impact of certain proposals on small business and the importance of clarity to avoid the all too frequent necessity of technical amendments to correct earlier oversight. Our comments are made in support of a Bill that is clear, specific and fair, and achieves the results of Congressional intent expressed in 1958.

The sponsors of S 2350 have requested comments on three ares not addressed in the Bill.

Tax impact of a Subchapter S election on shareholders

Should an S corporation election by an existing corporation be treated in effect as a liquidation of the corporation? The election is compared to a corporation that actually "converts" itself to a partnership, which latter action requires an actual liquidation of the corporation, bringing all of the applicable rules of Subchapter C into effect. We are opposed to any such provision for the following reasons:

1. The question presumes an inherent tax avoidance motive for an election, which is inconsistent with original Congressional intent for Subchapter S. The complexity and hidden traps in the existing provisions of Subchapter S are strong deterrents to election in many cases; inadvertent action, or inaction, can terminate an election, yet that termination may lie undiscovered for several years during which operations and distributions continue on the premise the corporation still qualifies.

2. No existing corporation with significant fair market value would elect. A corporation with either an operating history of good earnings or an accumulation of assets that has generated significant value, or a corporation formed only recently but owning assets with high value in relation to tax basis, could not afford to elect S corporation status regardless of the desirability of that form of operation. The shareholders would be taxed on a significant gain from which no cash or other funds are generated or otherwise available to pay the resulting taxes.

3. The election itself does not change the corporate structure or ownership of assets. An electing corporation would continue to be subject to the collapsible corporation rules of Section 341, all rules of recapture, etc.. We see no potential for tax abuse by an existing company that elects S corporation status and continues its activities as before.

4. There is apparent concern that an S corporation election may permit an operating company to sell its assets (in which it may have a high tax basis), and retain the proceeds within the corporation rather than liquidating. We believe this problem can be addressed satisfactorily without blanket imposition of the costly burden of treating an S corporation election as a de facto liquidation; we will cover this point specifically in our discussion of the passive investment income limitation.

There are major practical, business and economic effects of any proposal to levy a tax at the time of an S corporation election, and we urge full consideration of all points of view. The question of inherent possibility for tax avoidance or abuse is raised without allusion to any specific examples. In the absence of serious, practical study and discussion of the matter, legislation that treats an S corporation election as a de facto liquidation may result by default, causing unintended harm to many small businesses. The practical effect of any such provision may be limitation of the availability of

Subchapter S to new corporations electing immediately after incorporation.

The "Description of H.R. 6055: Subchapter S Revision Act of 1982" prepared by the staff of the Joint Committee on Taxation, dated June 8, 1982, addresses this matter on pages 25 and 26. Analogies are drawn that are not realistic. An S corporation election cannot be likened to the actual liquidation of a corporation.

The assets of a liquidating corporation are physically and legally transferred to the shareholders, who pay a tax on recognized gain and take the liquidating fair market value of the assets as their tax basis. If the assets are primarily of an investment nature, the assets themselves are usually distributed pro rata or partitioned among the shareholders. An operating company, on the other hand, will usually sell operating assets, pay its liabilities, and distribute the remaining proceeds to its shareholders, liquidating under Section 337. It is impractical to distribute undivided interests in operating assets except where the business operation may be continued in a partnership. In any case, each shareholder has actual ownership and control of his/her respective share of the corporate assets, and is free to do with them whatever he/she may want.

An S corporation election does nothing to affect asset ownership; the assets remain in corporate solution and the tax basis of the assets does not change. The only change is taxation of the income from the business directly to the shareholders rather than to the corporation, which is, after all, the purpose of Subchapter S.

A closely-held corporation considering liquidation followed by continued operation of the business in any form must consider the following:

1. Liquidation in order to operate as a partnership is financially attractive only if the step-up in asset basis to fair market value applies principally to assets for which the cost will be recovered against income in the very near future, such as inventory, receivables, assets with very short ACRS or amortization lives, etc. There is no economic benefit to a current capital gains tax that is larger than the present value of the tax benefit of the step-up.

2. A plan to liquidate a corporation and contribute operating assets to a new corporation at the stepped-up basis will not work. The Internal Revenue Service has consistently won cases classifying such transactions as tax-free reorganizations under either Section 368(a)(1)(D) or 368(a)(1)(F). The results are (1) no step-up in basis and (2) any cash or other assets retained taxed as ordinary dividends to the extent of accumulated earnings and profits of the "liquidated" corporation.

A reference to Section 333 (the "one month" liquidation) in the Joint Committee explanation seems misleading. Regardless of other considerations, a major factor in such liquidations is low accumulated earnings and profits. A Section 333 liquidation may then be attractive for a corporation with appreciated assets and low liquidity. Given a corporation that is a candidate for a Section 333 liquidation and also qualifies for Subchapter S, we believe the actual liquidation to be the better choice in nearly every case. We can find nothing here to indicate any support for treating an S corporation election as a liquidation.

Testimony before the House Subcommittee on Select Revenue Measures indicates concern over the step-up in the tax basis of the stock at death, which, as pointed out several times, is not unique to S corporations. The beneficiaries of a shareholder of any C or S corporation benefit from the step-up in basis at death. The stock may be redeemed from the estate or beneficiaries of that shareholder at little or no income tax cost under existing law. The S corporation rules do not and will not provide any unique opportunity for tax benefit in that area.

The Debt/Equity Regulations and the Single Class of Stock

The regulations under Section 385 are presently scheduled to apply to debt instruments created on or after April 1, 1983, and will require the treatment of certain debt instruments as preferred stock for all purposes of the Internal Revenue Code. This treatment for an S corporation would automatically cause termination of the election under existing Section 1371(a)(4) and proposed Section 1361(b)(1)(D). Debt instruments that meet the safe harbor requirements of the Section 385 regulations would cause no problem, but we believe there is no sound tax reason for leaving any uncertainty with respect to debt/equity treatment of shareholder debt and S corporations. S 2350 should provide exceptions or safe harbor rules to protect S corporation status.

The House Subcommittee on Select Revenue Measures has recommended changes in H.R. 6055 by adding proposed Code Section 1361(c)(5) to address the Section 385 question. We support the proposed change to provide a safe harbor for straight debt owed to one who would be a qualified S corporation shareholder, and urge inclusion of the same provisions in S 2350.

The original purpose of Section 385 was to provide objective standards to govern the "thin corporation" issue whereby profits or capital distributions to shareholders might be made under the guise of deductible interest or nontaxable repayment of principal. There is no potential for such tax abuse by an S corporation. All income is taxable to the shareholders regardless of whether it might or might not be called interest on debt; classification of amounts paid as interest or dividends is largely academic. This matter has been addressed in detail in several court decisions, primarily Portage Plastics Co. Inc., 486 F. 2d 632; Amory Cotton Oil Co., 468 F. 2d 1046; and Shores Realty Co., Inc., 468 F. 2d 572. In each case, the court found that classification as debt or equity was not important to the Subchapter S qualification of the corporation. We believe the provisions of proposed Section 1366(e) that require reasonable compensation for the use of capital will cover any potential abuse for use of debt to shift income among family members.

We agree with the single class of stock requirement for an S corporation. The limitation was designed to eliminate the complexity that might exist with respect to income allocation between or among different classes of stock and shareholders. We believe the rules that would be required to cover situations where more than one class of stock was outstanding would be unduly complex and add to taxpayer misunderstanding and enforcement burdens.

Limitation on Foreign Gross Receipts

A Subchapter S corporation cannot receive more than 80% of its gross receipts from sources without the United States. We see no reason to continue this limitation. The provisions of Subchapter N, and particularly Subpart F, were designed to block opportunities for tax avoidance in overseas operations. An S corporation would be subject to all of the provisions of Subchapter N and we see no additional potential for tax avoidance.

The Subcommittee on Select Revenue Measures has recommended elimination of the foreign gross receipts limitation by deletion of proposed Code Section 1362(d)(4) from H.R. 6055. We support deletion of the same provision from S 2350.

The following comments relate to specific provisions of the Internal Revenue Code proposed in Section 2 of the Bill:

Ineligible Corporations - Section 1361(b)(2)

Existing Section 1371 permits a Subchapter S corporation to own a foreign subsidiary or a Domestic International Sales Corporation (DISC). The Internal Revenue Service has recently given specific approval to ownership of a DISC by a Subchapter S corporation in Private Letter Ruling 8211116. Accordingly we recommend that the phrase "without regard to the exceptions contained in subsection (b) thereof," be eliminated from proposed Section 1361(b)(2)(A). This recommendation is consistent with our suggestion and the recommendation of the Subcommittee on Select Revenue Measures that the foreign gross receipts limitation be removed from the law.

We see no opportunity for tax avoidance by permitting an S corporation to own a DISC or a foreign subsidiary; an electing S corporation would, as previously stated, be subject to all of the provisions of Subchapter N, and specifically Subpart F, with respect to controlled foreign corporations.

We also see no practical reason for prohibiting ownership of a DISC or a foreign subsidiary in light of the proposal to eliminate the foreign gross receipts limitation. There is nothing to prevent the S corporation shareholders from owning a DISC essentially on behalf of the S corporation, and the practical Federal income tax effect of that ownership would be the same as if the S corporation owned the DISC. There are many cases where local country law, liability exposure, or other sound business reasons support the need for a separate corporation to conduct business operations in the country in which the new corporation is formed. The ownership of such a foreign subsidiary by an S corporation would have the same tax effect as ownership of the foreign corporation by the shareholders of the S corporation.

Banks and insurance companies are classified as ineligible corporations. Certain state and federal regulatory rules may prohibit operation of a bank or an insurance company in S corporation form, but we believe such entities should be allowed to choose S corporation status if it is permissible under applicable state and federal regulations.

Filing of Shareholder Consents - Section 1362(b)(2)(B)(ii)

Existing Regulation 1.1372-3(c) permits an extension of time for filing of shareholder consents where reasonable cause is shown for the failure to file such consents on a timely basis. Proposed Code Section 1362(b)(2)(B)(ii), taken literally, is a change which would automatically defer the effective date of an otherwise timely S corporation election to the next succeeding taxable year if all of the consents are not filed by the due date of the election. We recommend that this provision of the Bill be changed to make it clear that an extension is possible under the same conditions as those stated in existing regulations, and under those circumstances an otherwise timely election will be effective for the taxable year in which it is filed rather than for the next taxable year.

Revocation of Election - Section 1362(d)(1)(B)

The heading "One-half of Shareholders Must Consent to Revocation" is in error. Under the proposal, consent is required by shareholders owning more than one-half of the shares of the corporation's stock. The Subcommittee on Select Revenue Measures has recommended the heading be changed to, "More Than One-Half of Shares Must Consent to Revocation." We support a similar change in S 2350.

Passive Investment Income Limitation - Section 1362(d)(3)

The existing passive investment income limitation would be retained for an S corporation having accumulated earnings and profits at the close of a taxable year in which passive investment income exceeds 20% of the gross receipts. (The Subcommittee on Select Revenue Measures has recommended minor exceptions, but they would affect only a few S corporations under limited circumstances.) The original purpose for the passive investment income limitation was to prevent taxpayers from incorporating their investment assets in order to pay themselves salaries and establish a qualified pension or profit sharing plan. The result for a Subchapter S corporation would have been the ability to convert investment income into personal service income and defer taxation on the part of that investment income dedicated to funding the retirement plan. Tax legislation in recent years, including the Tax Equity and Fiscal Responsibility Act of 1982, has eliminated the incentive and opportunity. The original reasons for the passive investment income limitation no longer exist.

We understand the only specific concern leading to retention of the passive investment income limitation in the Bill is the possible opportunity for a corporation with a relatively high basis in its assets, compared to the shareholders' basis in their stock, to elect S corporation status, sell its assets, pass a lower gain through to the shareholders, and then remain in existence as an investment company.

The impact of this provision extends far beyond such situations. The passive investment income limitation would apply to almost every Subchapter S corporation in existence on the effective date of the Bill, or to any regular corporation that elects S corporation status after the effective date of the Bill. Outside of the above concern, there is no reason for continuation of the passive investment income limitation; the complete pass through of all items of income and expense to the shareholders and the removal of the distinction between earned and unearned income (enacted in 1981) for individual tax purposes eliminates the possibility for unintended benefit.

We recommend that precise language be included to apply to the specific situation of corporations that sell appreciated operating assets and remain as investment vehicles as follows:

1. An S corporation with accumulated earnings and profits that sells all or substantially all of its operating assets, and has more than 80% of its total gross receipts from passive investment income during the three taxable years following the year of such sale, would have its election terminated as of the beginning of the taxable year in which the sale occurred, and the corporation would be classified as a personal holding company and taxed accordingly.

2. The statute of limitations will be extended for such corporations and consistent reporting requirements will be included.

We also recommend a change in the definition of passive investment income to provide the same exceptions for rent as those in the personal holding company rules and codification of the "significant services" exception of Regulation 1.1372-4(b)(5)(vi).

We believe these changes would prevent the perceived possibility for abuse, while at the same time recognize that the owners of a company may decide to sell the assets used in the existing business and enter a new one. The three year "grace" period would provide reasonable time between the sale and active operation of the new business to allow for delays in acquiring the assets to be used in the new business, lack of operating income during the start-up period, etc.

The retention of the passive investment income limitation in any form may become inextricably linked to the theoretical liquidation issue, as though they are one and the same. They are not. The Joint Committee report describes the specific concern leading to the proposal on page 28. We believe our recommendation is an effective, practical alternative; it is directed specifically at the potential for abuse without affecting the many legitimate, operating businesses that could be trapped by the proposal in the Bill regardless of lack of intent to convert to an investment vehicle.

An elective "toll charge" has been proposed as an alternative; the proposal is neither practical nor equitable. A C corporation converting to S corporation status could elect to incur the toll charge, pay capital gains tax on one-fifth of the calculated amount each year for five years, and thereby "purge" itself of accumulated earnings and profits and exposure to the passive investment income limitation. A corporation having accumulated earnings and profits that chose not to incur the toll charge would remain subject to the passive investment income test.

The proposal is unduly complex. We also believe the absence of definition of any specific opportunity for tax avoidance other than the aforementioned conversion from operating to investment status is a glaring weakness. There are only hints at such possibilities that may generate the impression of potential abuse. There are severe practical problems, however, which must be considered:

1. The toll charge would not, in fact, be elective. No corporation could afford to pass up the election and risk loss of S corporation status at some unknown point in the future when passive investment income might exceed 20% of total gross receipts for reasons beyond its control and which could not possibly be anticipated at the date of the S corporation election. The following illustrations show how easily that could happen:

   - A construction company may experience a taxable year with little or no gross receipts from operations because of a severe downturn in the construction industry, with no jobs in process to generate gross receipts under any method of accounting. A company with the financial strength to survive the current housing slump, for example, would have available working capital invested in interest-bearing deposits until activity picks up.

   - Any company able to accumulate working capital to see it through a rough period would be in danger. Sound business practice dictates investment of working capital in a manner that permits immediate access to the funds while earning income until the funds are required in the business. Investments satisfying both criteria will always generate passive investment income.

2. The toll charge mandates actual distributions by the corporation so the shareholders can pay the tax. This may cause a serious liquidity problem for many corporations. A construction company required to make such distributions would experience a significant reduction in its bonding capacity, thereby reducing the size of construction jobs on which the company may bid. This would obviously curtail the earning capacity of the company.

The toll charge would require legislation to prohibit election in and out of S corporation status in order to withdraw accumulated earnings and profits at long-term capital gains rates. Any corporation that elects S corporation status, elects to pay the toll charge, and then terminates the S corporation election after five years or less must be presumed guilty; there is no practical way to gauge the intent of the shareholders. The restrictions would have to operate on the theory that such a corporation is guilty unless it can prove its innocence.

We urge the Committee to consider this whole area carefully and thoroughly before completing work on S 2350. We do not believe the possibilities for abuse are strong enough to warrant retention of the passive investment income limitation.

Inadvertent Termination - Section 1362(f)

The Bill gives the Secretary the discretion to determine whether a termination under proposed Section 1362(d)(2), (3) or (4) was inadvertent, permitting the corporation to continue the election. This language is too subjective and will eliminate any possible benefit from the provision until regulations are prescribed to set forth the conditions under which a termination will be considered inadvertent. We recommend that specific guidance be given the Secretary, and taxpayers, or that a specific description of conditions under which a termination will be considered inadvertent be included in the Bill.

In the absence of specificity, a corporation undergoing a termination would be forced to operate under the assumption that it was no longer a qualifying S corporation until such time as the determination were made. This might impose a severe hardship on the shareholders by preventing definite planning for their personal tax situations during the intervening period. Attention to possible application of the mitigation rules would also be necessary. If the passive income and foreign gross receipts limitations are removed as we have suggested, we believe sufficient guidance exists in private letter rulings issued under existing Section 1372(f) for specific rules that might be incorporated in the Bill.

Basis in Shareholders' Investment - Section 1366(d)(1)(B)

Many legitimate financing transactions involve the advance of credit by an unrelated third party lender to an S corporation, with that debt guaranteed by the shareholders. The shareholder guarantee is a bona fide requirement imposed by the lender as a condition for making the loan. Under both existing Subchapter S law and the Bill, debt guaranteed by shareholders is not included in tax basis to determine the limitation on deduction of losses. This has led to unrealistic financing arrangements where the shareholders borrow the money individually and then loan it to the corporation. The problem is typified by the recent Tax Court Memorandum decision in Gilday v. Commissioner, TC Memo 1982-242. The lender looks primarily to the creditworthiness of the shareholders rather than that of the corporation. The usual business transaction is a loan to the person or entity that will use the funds (the corporation), but a lender really looks to the shareholders until the corporation can establish a financial history to support borrowing without the guarantees.

The shareholders may not have made an out-of-pocket investment, but they bear the economic burden of the obligation, i.e., they are "at risk", until the debt is retired by the corporation or they are called upon under the guarantee. In a partnership, on the other hand, a general or limited partner is entitled to include in basis the amount of outside debt for which he may have personal liability either through operation of law or by individual assumption.

The unlimited carryover of disallowed losses and deductions provided by proposed Section 1366(d)(2) may allow eventual deduction of the loss in many cases, but we believe the shareholders should be allowed to claim the deduction currently where they have personal liability for obligations of the corporation, in keeping with the overall intent to more closely parallel partnership treatment.

We recommend that provisions similar to those in Subchapter K be included to permit the addition of guaranteed debt to basis for this purpose, and to treat repayment of that debt by the corporation as a constructive cash distribution to the shareholders.

Distributions and Adjustments to Basis - Sections 1367 and 1368

The Bill is not clear on the interrelationship between distributions under proposed Sections 1363(d)(1) and 1368(b) and (c), and adjustments to basis under proposed Section 1367. Adjustments to basis ordinarily can be made only after the end of the S corporation's taxable year when all necessary information is available to determine each shareholder's income or loss under proposed Section 1366. A distribution to a shareholder during an S corporation taxable year would always be in excess of basis at the date of distribution if the shareholder's basis in stock were zero, resulting in gain under proposed

Section 1368(b)(2), even though the source of the distribution is current year's earnings.

The treatment of distributions of current income, which are from current earnings and profits under existing law, should be clearly defined. We recommend that proposed Section 1368(d) be clarified to state that adjustments to basis and the accumulated adjustments account for any S corporation taxable year will be made before determining the effect of distributions under proposed Section 1368(b) or (c). This is consistent with the provisions of Regulation 1.731-1(a)(1)(ii) with respect to distributions of current income by a partnership.

Foreign Loss Recapture - Section 1373(b)

A corporation would be required to report as taxable income any previous overall foreign loss either upon making an S corporation election or terminating an existing election.

We believe this provision is unduly harsh. An S corporation election should not cause recognition of income not yet realized. The provisions of existing Section 904(f) should continue to be applicable to the corporation, and foreign source income treated as income from sources within the United States for purposes of the foreign tax credit.

The provision for recapture upon termination of an S corporation election may be appropriate, but only to the extent the shareholders have received the benefit of a deduction for foreign losses on their individual returns.

Post-Termination Transition Period - Section 1377(b)(1)(A)(ii)

We believe the last word in this sentence should be "or" rather than "and". It appears the 120 day period following determination that the corporation's election has terminated is an alternative to the period specified in subparagraph (A).

Changes in Stock Ownership - Section 1378(c)(1)

The unlimited period for measurement of a cumulative change of ownership of more than 50% seems unreasonable. We recommend limitation to a cumulative change of ownership during a period of any three consecutive taxable years, beginning with the first taxable year following the taxable year that includes December 31, 1982. This is consistent with other provisions of the Internal Revenue Code that prescribe certain limitations, etc., following a stipulated change in ownership, such as existing Section 382(a)(1)(A) or Section 708(b)(1)(B). We do not believe it is unreasonable to prescribe a three year time limit for the change in ownership.

Newly Owned Stock - Section 1378(c)(2) and (3)

A change in ownership of an S corporation by redemption from a shareholder or gifts of stock by existing shareholders to family members would be "Newly Owned Stock" under the Bill. We recommend exemption of a gift or of redemption under the provisions of a shareholders' agreement that provides for redemption of stock when a shareholder leaves the employ of the corporation, retires, or dies. Agreements with provisions for redemption under the above conditions are generally advisable for closely held corporations, regardless of whether they are S corporations. We believe a change of ownership as a result of the type of redemption that protects the ongoing business should be excluded from these rules.

We also suggest that specific language be included to state that a transfer by reason of death includes a transfer to a testamentary trust and the subsequent transfer of the stock by the trust to its beneficiary(ies).

Distribution of Previously Taxed Income - Section 1379(c)(1)

Under existing law, Previously Taxed Income (PTI) can be distributed to the shareholders free of additional tax during any succeeding taxable year covered by the election. A distribution of PTI comes before any distribution of an ordinary dividend from accumulated earnings and profits, and there is no time limit.

The Bill, however, would require distribution of PTI from preenactment taxable years no later than two and one-half months following the close of the first postenactment taxable year. For an S corporation with accumulated earnings and profits, failure to make the distribution within that restricted time period would require distribution of any accumulated earnings and profits as ordinary dividends before a nontaxable distribution of PTI could be made. We believe this is unintended, and unreasonably harsh.

There is no incentive, tax or otherwise, for an S corporation to withhold distributions of PTI. Accumulation of PTI is the the result of cash shortages, loan restrictions, or other business conditions preventing distribution. Those limitations are likely to continue in many cases, and there is no reason to place a new restriction on such distributions.

The Subcommittee on Select Revenue Measures has recommended a change in proposed Section 1379(c) to apply the rules of existing Section 1375(d) and (f) to distributions of undistributed taxable income from any taxable year beginning before January 1, 1983. We support the change, but suggest clarification in proposed Section 1368 with respect to the order of distributions. We recommend insertion of language in proposed Section 1368(b)(1) to include distributions described in proposed Section 1379(c), and in proposed Section 1368(c), as new paragraph (2) (renumbering paragraphs (2) and (3) as (3) and (4)), to provide that distributions under Section 1379(c) precede any from accumulated earnings and profits.

Bill Section 3

Effect of Election on Depletion - Section 3(a)

An S corporation election by a regular corporation would be treated as a transfer of proven oil and gas properties, denying to the shareholders the deduction for percentage depletion under the independent producer exemption. This is inconsistent with proposed Regulations 1.613A-3(h), Example (19), and 1.613A-7(n) and (o). An S corporation election would not change the "legal or equitable ownership" of the properties, and should not be treated as a transfer.

Under existing law, the deduction for percentage depletion in excess of cost is an adjustment to earnings and profits of a corporation. The cash represented by a percentage depletion deduction cannot be distributed tax-free by a Subchapter S corporation; it is a distribution of a dividend from either current or accumulated earnings and profits. A corporation that owns proven oil and gas properties might make an election in order to permit a nontaxable distribution of the depletion deduction to its shareholders in the absence of some restrictions. Treating the election as a transfer, however, as under the Bill, seems unnecessarily harsh. We suggest the definition of the "Accumulated Adjustments Account" in proposed Section 1368(e)(1)(A) be changed to provide for a reduction of the account by the percentage depletion deduction claimed by a shareholder with respect to proven oil or gas properties owned by the corporation at the date of the election. The depletion deduction would still be allowed, but withdrawal of the cash would be subject to proposed Section 1368(c)(2).

Payments to Shareholders - Section 3(g)(2)

An S corporation would effectively be placed on the cash basis for any amount paid or incurred to a shareholder who owns more than 2% of the outstanding stock, directly or indirectly, if the amount would not be includable in the recipient's income in the same year it would otherwise be deducted by the corporation.

We understand the major reason for the 2% ceiling is the possible abuse by a professional corporation with fifteen to thirty-five shareholders, for example. We recognize the opportunity for abuse under the existing provisions of Section 267 in such cases, but we believe this should be addressed directly. There are many cases where a key employee who is not related to the major shareholders acquires a stock ownership interest in the corporation as an incentive. Such individuals usually have little voice in shareholder affairs unless their ownership increases to or above the 10% level, and the potential for tax abuse under Section 267 is limited with respect to shareholders owning less than 10% of the stock.

We strongly recommend the 2% ownership limit be increased to 10%, with the exception of entities described in Section 535(c)(2)(B) that would be subject to the 2% test. This would eliminate the possibilities for abuse by a personal service corporation without unreasonable restrictions on regular business corporations.

Other Matters

Investment Tax Credit - At Risk Rules

The provisions of Code Sections 46(c)(8)(C) and 46(c)(9), as interpreted by the Joint Committee, place unrealistic limitations on shareholders in Subchapter S corporations. Our Firm's comments on proposed technical corrections include a full statement on this problem, and we mention it here only for emphasis on the importance of the issue for the Committee's consideration.

Self-Employment Income

We recommend amendment of Section 1402(a)(12) to provide that a shareholder of an S corporation will be treated the same as a limited partner with respect to his/her distributive share of the corporation's income. The distributive share should not be included in net earnings from self-employment.

Fringe Benefits

We oppose the provisions of proposed Section 1372(c), which would effectively deny fringe benefits to shareholder-employees of S corporations. There is a real difference between the status of a shareholder who is also an employee and a partner who renders services to the partnership. Existing law includes adequate safeguards against abuse of the fringe benefit area, and the treatment of shareholder-employees of S corporations should be no different than that of shareholder-employees of any other closely-held corporation.

Undistributed Income at Date of Death

Testimony of others before the House Subcommittee on Select Revenue Measures recommended treatment of undistributed income at the date of death as income in respect of a decedent subject to Section 691, when a shareholder dies during a taxable year of an S corporation. We support that recommendation.

The Subcommittee, however, elected to change proposed Section 1366(a)(1) to require inclusion of undistributed income at date of death in the shareholder's final return. This proposal is inconsistent with the overall intent to bring the treatment of S corporations into line with that of partnerships, and specifically inconsistent with Section 706(c)(1) and Regulations 1.706-1(c)(3).

We recommend treatment of the undistributed income share of an S corporation shareholder who dies during a taxable year of the corporation in the same manner as that of a partner who dies during a taxable year of the partnership. This treatment is not only more equitable and consistent with the overall intent of the Bill, but also eliminates the question of how income should be reported where the stock is owned by both spouses as community property.

We would like to thank you for the opportunity to testify at this hearing. We urge the Committee to consider our recommendations before completing action on this important legislation. We will be happy to answer any questions that members of the Committee or its staff may have concerning our comments and recommendations, or to furnish any additional information requested.

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STATEMENT
OF
RICHARD A. SHAW

Chair, Taxation Section of the State Bar of California

Finance Committee

United States Senate

September 10, 1982

Hearings on S 2350
The Subchapter S Revision Act of 1982

INTRODUCTION

My name is Richard A. Shaw. I am the Chairman of the Taxation Section of the State Bar of California. I am representing the 2,500 members of our Taxation Section. The views which are expressed represent only the views of the Taxation Section, since they have not been reviewed by the Board of Governors of the California State Bar.

Personally, I have been substantially involved with Subchapter S of the Internal Revenue Code for approximately 20 years and have served as Chairman and Special Advisor of the American Bar Association Tax Section Committee on Subchapter S and also as Chairman of the California Tax Section Subcommittee on Subchapter S.

RECOMMENDATION

The California Tax Section is pleased to recommend the prompt enactment of S-2350, the Subchapter S Revision Act of 1982. It represents a positive comprehensive simplification of a complex area of tax law which is long overdue.

When Subchapter S was created in 1958, it was done so with the intent that taxpayers should be able to practice in a corporate form without having income taxed first at the corporate level and then again upon distribution to the shareholders. Although earlier proposals in 1954 had designed a concept to tax the shareholders as partners, the Subchapter S law created in 1958 was designed to tax all current taxable income as dividends to the shareholders whether distributed or retained at the corporate level. Only capital gains are passed through to shareholders. In addition, a system was formulated to permit subsequent distributions of previously taxed income without taxation to the shareholder at the time of distribution. In order to keep administration simple and to prevent tax abuse, extensive controls were established on eligibility, on the nature of permitted income, on operations and on distributions.

Even though the initial objective was commendable, it has been evident for the last 24 years that the complex formulas to integrate the various segments of the new system and the many safeguards incorporated to prevent abuse have caused Subchapter S to be recognized as one of the foremost traps for the unwary in the Internal Revenue Code. Although substantially improved through the years, the eligibility conditions have been a constant concern and cause for frequent inadvertent terminations. Although simplifying the tax system, in part, by characterizing the corporate income as dividends, the statutes developed a complex maze of operational priorities and restrictions which must be traversed before shareholders can determine whether to treat subsequent cash or property distributions as taxable dividend distributions from current earnings and profits or from accumulated earnings and profits, or as nontaxable distributions of previously taxed income or possibly as returns of capital or distributions subject to capital gain treatment. The complexities of the system and the risk of error or inadvertent termination has been such that many practitioners have encouraged taxpayers to avoid Subchapter S unless prepared to undertake the costs and efforts involved with constant supervision. As a result, Subchapter S has never obtained its full potential for offering small groups of individuals the opportunity to select the corporate form of business while retaining a simple single level tax structure.

The proposed Subchapter S Revision Act of 1982 offers substantial revisions which go a long way toward eliminating inadvertent hardships and assists a great deal towards tax simplification.

In evaluating S-2350, we recognize that the proposed bill has had the unique benefit of substantial staff input from governmental agencies and from private tax practitioners which spans more than 15 years. As a result of the extensive cross fertilization of information and the incorporation of many suggestions previously made by the private sector, S-2350 already contains many of the features and refinements which we believe are necessary for a more effective Subchapter S election and for good income tax simplification. In general, it is the belief of the California Taxation Section that the bill will make the administration and enforcement of Subchapter S more efficient and more certain for both the taxpayer and the government.

In the balance of this statement, we would like to direct our attention to selected aspects of the bill. Comments will be brief, recognizing that more substantive detail can be furnished in subsequent technical comments.

GENERAL DISCUSSION

1. NUMBER OF SHAREHOLDERS

Since Subchapter S by its nature is most suitable for a small number of shareholders, it has been the belief of many members of the Taxation Section that a shareholder limit is arbitrary and unnecessary. To the extent that some number is deemed necessary, the Section favors the proposed limit at 35 shareholders. This will minimize the risk of inadvertent termination resulting from the growth in the number of shareholders caused by sales, gifts, death or other estate planning.

2. STOCK OF VOTING RIGHTS

The Section endorses the recommendation in Section 1361(c)(4) that differences in voting rights should be permitted among shares of common stock. Differences in voting rights among Subchapter S shareholders has no negative impact on the tax consequences, does not effect administration and would not cause any tax abuses. In addition, statutory recognition would be consistent with case law which recognizes that private proxies and voting agreements do not cause a second class of stock. Parker Oil Company, Inc., 58 T.C. 985 (1972).

3. DEBT AS A SECOND CLASS OF STOCK--SECTION 385

Although the present bill makes no reference to Section 385, inquiries have been raised concerning the appropriateness of established guidelines in Subchapter S for determining when debt should be treated as equity. It is the position of the Tax Section that Section 385 Regulations are not appropriate for Subchapter S. In a series of cases in the 1960s and early 1970s,

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culminating in James L. Stinnett, Jr., 54 T.C. 221 (1970), Amory Cotton Oil Co. v. U.S., 468 F.2d 1046 (5th Cir. 1972) Shores Realty Co., Inc. v. U.S., 468 F.2d 572 (5th Cir. 1952) and Portage Plastics, Inc. v. U.S., 468 F.2d 632 (7th Cir. 1973), it has been established that the thin corporation doctrine testing the ratio of debt to equity in a corporation has no applicability for Subchapter S corporations. Since all income is taxed to shareholders when earned by the corporation there is little tax avoidance motivation for characterizing later distributions as return of loaned principal. While a payment of interest to a shareholder-lender by a C corporation is deductible, and payment as a dividend is not deductible, the issue is not material to a Subchapter S corporation. Likewise, the Courts recognize that Congress anticipated significant shareholder advances to the corporation by permitting losses to be taken by shareholders to the extent of shareholder loans in present Section 1374.

To the extent that there might be a potential opportunity for shifting any tax consequences, it is believed that new Section 1366(e) will cover the situation. That section will now permit the Secretary to make adjustments between members of the family group to more clearly reflect the value of services or capital furnished to the corporation by family members. In addition, the new provisions will incorporate the principles of Section 267 which would prohibit the corporation from taking a deduction for unpaid expenses and interest unless they are concurrently taken into income by the shareholder.

It has taken the Treasury Department 13 years to draft the present extremely complex proposed debt-equity regulations under Section 385. The regulations would breed uncertainty and confusion in an arena where they do not fit. The potential problems can be seen quickly by examining the proposed §385 regulations. The Commerce Clearing House publication setting forth the proposed regulations is 52 pages long. It took the Treasury Department 43 pages to define its interpretations as to when instruments represent equity or debt and another 9 pages to explain what it meant in drafting the proposed regulations. We do not believe it is realistic to expect the small mom-and-pop grocery store owners to become familiar with the intricate details of those 52 pages. Should mom or pop be wrong in guessing when their "debt" is debt under the regulations, they would automatically suffer the destruction of their Subchapter S election. Instead of making Subchapter S more attractive, the adoption of the proposed §385 regulations to Subchapter S would drive many small businessmen away because of their unwillingness to bear the risks in second guessing the extremely complex guidelines in the regulations.

In addition to the definitional problems created by the regulations, we prefer not to further styme the efforts of small business in obtaining loans in a modern financing world which constantly tests the creative imagination of financial institutions.

After evaluating these considerations and recognizing the importance of keeping Subchapter S simple, it is our recommendation that Section 385 and its regulations are not suitable for Subchapter S. Since case law has completely settled the thin capitalization issue, we believe that simplification is best served by remaining at the status quo. The Taxation Section recommends that the bill be amended to specifically provide that Section 385 shall not apply to Subchapter S.

The Taxation Section supports the amendment made by the House of Representatives Committee on Ways and Means to HR-6055 which would create a safe harbor for any straight debt which is held by a person who is eligible to hold Subchapter S stock. However, there is no logical reason to limit the safe harbor to persons who are eligible to hold stock in the corporation. Once an instrument is classified as "straight debt", (that is, a written unconditional promise to pay on demand on a specific date a sum certain in money at a fixed rate, with no conversion right) it will always be debt and not equity under Subchapter S. Therefore, it would not be a second class and it should not matter who owns the debt. Therefore we recommend a general safe harbor for all "straight debt". In addition, it is our conclusion that it would not be beneficial for the Treasury Department to attempt to prescribe regulations restricting safe harbor instruments which might otherwise be treated as equity under other provisions of the Tax Code, since the above cited Court of Appeals cases have consistantly concluded that the guidelines under Subchapter S are significantly different than those applicable to standard Subchapter C corporations.

4. PASSIVE INVESTMENT INCOME--GENERAL RULE

S-2350 will eliminate the passive investment test for corporations which do not have accumulated earnings and profits. This is a very positive step forward. The passive investment income test was initially created to prevent passive investors from utilizing Subchapter S corporations to obtain corporate fringe benefits not otherwise obtainable. Since retirement plan benefits are now available to individuals and partnerships, there is general consensus that there is no real need for a passive investment income test for simple Subchapter S corporations.

5. PASSIVE INVESTMENT INCOME - THE ACCUMULATED EARNINGS AND PROFIT LIMITATION

The bill proposes to retain the 20% gross receipts limitation on passive investment income when the electing corporation has accumulated earnings and profits.

Historically, there was an agreement by the Treasury Department in 1969 that it would support the complete elimination of the passive investment income test if the American Bar Association would agree to support the limitations on retirement plan benefits proposed in Section 1379 for Subchapter S. In the Tax Reform Act of 1969, as enacted, the HR-10 - Keogh type retirement plan limitations were adapted but the passive investment income restriction remained intact. Although the Treasury

Department has now reversed its position, the Staff of the Joint Committee on Taxation, in its April 30, 1980 recommendations for comprehensive revision to Subchapter S, continued to support complete elimination of the passive investment income test for all purposes. The California Taxation section believes that the passive investment income test should be eliminated entirely in the interest of simplification.

The sponsors of the bill have raised a potential area of concern where accumulated earnings and profits exist at the time that the Subchapter S election is made. In this one situation, one can postulate the existence of an operating business which has accumulated earnings and profits as a C corporation. The corporation then sells the operating assets, converts the proceeds to passive investments and continues the corporation as a Subchapter S corporation until the death of the shareholder. Upon the death of the shareholder, the successor in interest would have a stepped up basis in the stock and could liquidate the corporation without the accumulated earnings and profits ever having been taxed.

A pure analysis indicates that attention is being directed to the wrong tax issues. The improper tax avoidance, if any, in the hypothetical arises from the step-up in tax basis at death - a result which is sanctioned by the code after several years of re-evaluation and testing with carryover basis concepts in the 1970's.

The existence of accumulated earnings and profits at the time of the election has not been a problem for electing corporations and need not be one under the new system.

Under present law, there is no immediate tax impact when a corporation with accumulated earnings and profits elects Subchapter S. The existing accumulated earnings and profits are generally held in abeyance during the election. Annually, the shareholders are first taxed on current income and are then permitted to make tax free cash distributions of previously taxed income from prior election years. Only then would additional distributions be deemed to be from accumulated earnings and profits. This system has worked effectively for 24 years and shows no signs of abuse.

Even the new general proposal carries on a similar concept. Upon making the election, the accumulated earnings and profits are frozen. Under the bill, as income and expense items are incurred they will pass through to the shareholders. The shareholders will have an "accumulated adjustments account" pursuant to §1368(e), which accumulates the net income which is passed through to the shareholders. When distributions of cash from the corporation exceed the accumulated amount in the accumulated adjustments account, then any pre-existing accumulated earnings and profits would be taxed to the investors at ordinary income tax rates. The individual shareholders cannot withdraw any of the accumulated earnings without suffering an immediate tax.

This system for taxing accumulated earnings has been fair under present law and would be continued under the new law.

Thus, the real issue is whether it is necessary or proper to single out the Subchapter S corporations with accumulated earnings and profits for special tax restrictions because its shareholders might benefit from an unrelated tax provision providing for a stepped-up basis at death. We do not believe it is necessary or appropriate to selectively use Subchapter S corporations as a means of attacking general perceived wrongs with the stepped-up basis provisions in Section 1014.

If a decision is reached that some restriction should be retained upon passive investment income until accumulated earnings and profits have been distributed or otherwise taxed, we would support the contemplated recommendation of the American Bar Association Tax Section that the taxpayer be given an option to have the accumulated earnings and profits taxed at capital gain rates at the time of the Subchapter S election or thereafter in order to remove the accumulated earnings and profits.

In general terms, the American Bar Association recommends that any electing corporation with accumulated earnings and profits should be given an option to avoid the passive investment income restrictions by electing to have all accumulated earnings and profits taxed to the shareholders at capital gain rates, with the tax being paid in 20% installments over five years. There are special ordinary income recapture rules if the election is terminated during the five year period. We believe the concept has significance independent of the passive investment income issue and might be suitable for adoption even if the passive investment income test is dropped. The option may act as an inducement for many corporations to pay a lower capital gains tax now in order to have the additional flexibility in making distributions in the future. It should act as an effective revenue producing incentive. Accumulated earnings are frequently stored at the corporate level for many years and revenue collections accordingly deferred until later distribution. We recommend that the optional pick up capital gain tax on accumulated earnings be given serious consideration for inclusion in Subchapter S.

Should a test be preserved for limiting passive investment type income, then it is believed that the rules should not be as strict as they are at present. If the passive investment gross receipts test is retained in a manner similar to that existing in present Section 1372(e)(5), then it is recommended that the 20% limitation be increased to 50% and that the definition of passive investment income be revised to exclude some additional types of income. Thus, we support House of Representatives Ways and Means Committee proposals which would exempt income from the conduct of a lending or finance business and interest on deferred installment sales of inventory, and which would include only the net gain from the sale or exchange of capital assets, other than stock or securities.

In lieu of retaining the passive investment income gross receipts test, it is recommended that serious consideration be given to the utilization of the personal holding company tests under Section 541. Under such a rule, the Subchapter S election would be terminated in any year in which there are accumulated earnings and profits at the end of the year and the corporation is a personal holding company as defined in Section 542. A corporation would be a personal holding company if at least 60% of its adjusted ordinary gross income for the taxable year is personal holding company income and if at any time during the last half of the taxable year more than 50% in value of its outstanding stock is owned directly or indirectly by not more than five individuals. Under this system, Subchapter S would be applying a set of rules which have been traditionally used for restricting passive investment activities of small groups of investors. This rule would be applied in conjunction with the capital gains option proposed by the American Bar Association for currently removing accumulated earnings and profits.

Should a passive investment income test or personal holding company test be imposed upon electing corporations with accumulated earnings and profits at the end of any year, then it is recommended that accumulated earnings and profits be defined for Subchapter S purposes as including accumulated earnings or profits arising only prior to the election. This restriction is necessary since tax exempt income and some accounting adjustments (*e.g.*, §1377(d) and §312(k) relating to depreciation) may cause a Subchapter S corporation to generate accumulated earnings and profits under present law even though the earnings are not currently taxed to the shareholders.

Proposed Section 1362(d)(3) continues the present provision in Section 1372(e)(5) which provides that the passive investment income restriction does not apply to a new Subchapter S corporation during its first two years if the passive income is less than $3,000. This is designed to permit a new corporation to invest its assets temporarily until the business operation gets started. Recognizing the impact of inflation and higher interest rates, it is suggested that the $3,000 limit be raised to a higher figure, not less than $10,000.

6. LIMITATION ON FOREIGN INCOME

Although earlier Treasury Department proposals have recommended deletion of the 80% foreign gross receipts test, it is noted that S-2350 retains the present provision which terminates the Subchapter S election if more than 80% of gross receipts are derived from sources without the United States. It is believed that this is the result of an abundance of caution. In our review, members have ascertained no problems which warrant the continuation of this test and recommend its elimination. The Section supports the House of Representatives Ways and Means Committee amendment which would repeal the 80% foreign gross receipts test.

7. STATE CORPORATION LIMITATIONS ON SECURITIES

A significant problem with the second class of stock limitation applies in the state of California and may apply in similar states. The California Department of Corporations reserves the right to condition the issuance of stock for services upon a restriction that the promoter agree to waive dividend distributions and to defer his right to payment on liquidation until cash paying shareholders have received a priority. In such case, both restrictions are generally removed as soon as the corporation becomes profitable. Ordinarily, such corporate securities restrictions may be lifted in California after a period of approximately three years. In Paige v. United States, 580 F.2d 960 (9th Cir. 1978), the Court treated dividend and liquidation restrictions as creating a second class of stock and invalidated the corporation. See also, Revenue Ruling 71-522, 1971-2 C.B.316. It is the recommendation of the Taxation Section that dividend or liquidation restrictions imposed by governmental agencies should not cause the corporation to be treated as having a second class of stock provided that the shareholders agree to taxation of the items of income and losses to the shareholders as if the corporate securities restrictions did not apply. We believe that the American Bar Association supports the California taxation section on this recommendation.

8. ELECTION REVOCATION AND TERMINATION

The Taxation Section supports in general the recommendations set forth in Section 1362 of the new bill dealing with election revocation and termination. The new provision that an election may be revoked by a majority of the shares of stock in the corporation is an improvement over the former requirement that 100% of shareholders must consent to the revocation. The former rule gave unreasonable economic powers to minority shareholders in controlling the future of the corporation. The removal of the right of a new shareholder to affirmative refuse to consent to the election is important for the same reasons. With 35 shareholders permitted under the new law, one new shareholder should not be permitted to control the economic destiny of the other 34 shareholders. The Section endorses the recommendation that disqualification will cause a termination to be effective as of the date of the event, rather than the first day of the taxable year as is the case under present law. The inadvertent termination rule under Section 1362(f) is an important remedial provision for correcting inadvertent terminations which are easily rectifiable by the corporation or its shareholders with the cooperation of the Secretary.

9. DISTRIBUTIONS OF APPRECIATED PROPERTIES

The bill proposes in Section 1363(d) that all distributions of appreciated property will cause a tax to the corporation as if the property had been sold to the distributee. We recognize the desireability of taxing ordinary income type properties in this manner in order to avoid the complex "hot asset" problems existing with partners under Section 751. However, we believe the Treasury proposal goes too far in taxing appreciation in capital assets or Section 1231 assets to the corporation. This is not consistent with the present scheme for taxing corporate distributions of appreciated property and is not necessary. We recommend that there be a pass through of basis to the shareholders upon the distribution of such capital assets or Section 1231 to the shareholders. Thus, they will have to pick up any tax resulting from appreciation on later disposition.

10. TAX TREATMENT TO SHAREHOLDERS

Among the most important parts of the new law are the provisions which provide that items of income, deduction, loss and credit will pass through to the shareholders and retain their character rather than being treated as dividends or capital gain under present law. For an electing small business corporation, this now establishes a more accurate method for truly reflecting the income to the shareholder and assuring that it will be taxed only once. The addition of a rule that provides that all items will be allocated on a per share per day basis also eliminates the variety of rules which now exists. Under present law, there is a last day of year test for income, an allocation based upon dividends for capital gains, and a per share per day test for losses. These different rules have frequently lead to confusion and are eliminated under the new law. The Tax Section supports the new provision which will finally permit a shareholder to carry forward any loss to the extent that the loss exceeds his aggregate basis in stock and debt to the corporation.

In general, new Section 1368 will establish a new set of rules for distributions which permit the distribution of cash by a corporation (which has no accumulated earnings and profits) to its shareholders without having a tax and without getting into the problem existing under current law of determining whether the distribution is one from undistributed taxable income or previously taxed income. This is a substantial improvement in Subchapter S and is consistent with the new format for treating items of income, deductions, credits and allowances as passing through to shareholders and being treated completely separate from distributions. This set of provisions in general is simpler in management and in the long view will be easier to use than the present system, since they apply rules similar to those applied in partnership taxation under Subchapter K.

11. DEFERRED COMPENSATION

The bill substantially reduces the qualified retirement plan benefits and other fringe benefits available to employee shareholders in a Subchapter S corporation. Under proposed Section 1372, the partnership rules for deferred compensation will generally be applied in determining retirement benefits and other fringe benefits for employees. Under the rules, any shareholder who owns more than 2% of the stock of the corporation will be treated as a partner and any shareholder who owns more than 10% will be treated as an owner/employee. The proposal fails to recognize that a true employer-employee relationship exists under corporate law and that those rules ought to be applied in examining that relationship in the tax atmosphere. It is believed that the artificial characterization of shareholder-employees as partners for some employment purposes will create more problems in the future than it will solve. Congress should encourage privately funded retirement plans in closely held businesses rather than impose additional restrictions which may tend to eliminate such privately funded retirement plans and thereby deprive rank and file employees of retirement benefits. In view of significant tax changes made by the Tax Equity and Fiscal Responsibility Act of 1982 to retirement plans of Subchapter S corporations, it is recommended that the entire concept proposed in new Section 1372 be reviewed and deleted. The Tax Equity and Fiscal Responsibility Act has undertaken to provide greater conformity in the taxation of retirement plans for all small businesses, including Subchapter S corporations. Any new changes should be integrated with the recently enacted legislation.

In connection with our evaluation of the application of partnership rules for "employee fringe benefits" our Section was faced with the prospect of finding no definition for the term. The vision of what is a fringe benefit depends on the eyes of the beholder. It is recommended that the concept be deleted and if it is retained, that the statute establish guidelines.

Should a decision be made to retain the new partnership rules for qualified retirement plans and fringe benefits, it is recommended that the two percent rule be increased substantially to five or ten percent.

12. CORPORATE FISCAL YEAR

Although some reservations have been expressed concerning proposed requirements for all Subchapter S corporations to adopt a calendar year, the Taxation Section in general supports the conclusion that the proposal in Section 1378 establishes a realistic guideline for new Subchapter S corporations. The Section believes that it is not necessary to require existing corporations to convert to a calendar year when there is a significant change in ownership in the future. As presently drafted, the statute would cause the corporation to change its fiscal year to a calendar year at any time when more than 50% of the stock is "newly owned stock", unless the change is the result of the "death of a person who held such stock" on December 31, 1982. This arbitrary 50% test will, in some instances, cause an unnecessary restraint on future alienation of stock in closely held S corporations since transfers must ultimately result in the fiscal year being changed in the future. If a percentage test is applied, it is recommended that a set of attribution rules, such as those applied in Section 267(b) and (c) be applied before a determination is made that there has been a more than 50% creation of "newly owned stock".

13. TREATMENT OF EXPENSES AND INTEREST IN TRANSACTION BETWEEN THE S CORPORATION AND STOCKHOLDERS

The bill amends Section 267 of the code to provide that the S corporation may not take a deduction for expenses or interest paid to a related person until the year in which the item is includable in the income of the related person. In general, the California Taxation Section supports this provision as it will reduce opportunity for a distortion of income which may exist when the corporation is on an accrual method and the related payee is on a cash method. We are concerned about overt discrimination against the Subchapter S corporation which will exist under the proposal since standard C corporations are currently given a 2 1/2 month grace period within which to make the payment after the end of the corporations year under §276(a) (2) but this privilege will be denied Subchapter S corporations. In addition, this new application of Section 267 will apply to Subchapter S corporations not to partnerships. We recommend that the 2 1/2 month payment rule be given to Subchapter S corporations.

14. SUMMARY

In conclusion, it is the belief of the Taxation Section of the California State Bar that the Subchapter S Revision Act of 1982 is a major improvement in federal taxation which will substantially simplify Subchapter S and will result in many more businesses taking advantage of the opportunity to engage in business in the corporate form without suffering significant economic detriments which may be caused by the dual corporate tax structure. The Taxation Section supports the enactment of S-2350, and requests that the Committee give serious consideration to the proposals and comments which we have made. Recognizing the many years of hard work which have gone into the development of this bill, we strongly encourage Congress to act on the bill this year.

Respectfully submitted,

Richard A. Shaw

Richard A. Shaw, Chair
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September 9, 1982

Chairman Robert Dole
Senate Finance Committee
Dirksen Building
Washington, DC

SUBJ: SUBCHAPTER S HEARING OF SENATE FINANCE COMMITTEE

Dear Senator Dole:

The following comments are being submitted to you and the full committee to be considered in your deliberations on Friday, September 10, 1982 involving the proposed revisions to Subchapter S (Tax Option Corporations), of the Internal Revenue Code.

Our objections with the present code deals with the provisions describing "passive income" which include interest received in gross receipts. This definition places undue burdens upon developers who frequently receive advance deposits prior to construction date and become entrapped by this definition so as to terminate their Subchapter S election. No offset is allowed for interest paid in determining passive income requirements under this present Code.

Internal Revenue Code §§ 1371 to 1378 govern Subchapter S corporations. Under these sections, the corporation may elect Subchapter S status and have its income taxed directly to its shareholders rather than to the corporation. In order to be eligible for such election, the corporation must meet prescribed requirements.

The Subchapter S corporation files an information return in lieu of a corporate tax return. However, if the Subchapter S status is terminated, the corporation would be liable for the regular corporate tax for taxable years in which the termination was applicable. The shareholders of the corporation, of course, must report income on their individual returns.

IRC §1372(e)(5) governs termination of Subchapter S status for corporations that have for any taxable year gross receipts more than 20% of which is passive investment income. There exists an exception to this rule as follows:

> (B) Subparagraph (A) shall not apply with respect to a taxable year in which a small business corporation has gross receipts more than 20% of which is passive investment income, if--
>
> (i) such taxable year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year; and
>
> (ii) the amount of passive investment income for such taxable year is less than $3,000.

Passive investment income is defined as "gross receipts derived from royalties, rents, dividends, interests, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom)." If Subchapter S status is terminated due to its excessive passive investment income, IRC 1372(f) provides that the corporation shall not be eligible to make another election for any taxable year prior to its 5th taxable year following such termination, "unless the Secretary consents to such election." The Subchapter S status may also be terminated by (1) the failure of a new shareholder to consent, (2) revocation by the shareholders of the election, (3) cessation of the corporation to qualify as a small business corporation, (4) gross receipts of the corporation more than 80% percent of which are derived from sources outside the United States.

For purposes of determining the passive investment income percentage, the corporations "gross receipts" are used. Gross receipts is not synonymous with gross income. Gross receipts equal the total amount received or accrued under the corporation accounting method without reductions for deductions, returns or allowances, or costs. The regulations specify that "gross receipts will include the total amount received or accrued during the corporations taxable year from the sale or exchange (including a sale or exchange to which §337 applies) of any kind of property, from investment, and for services rendered by the corporation." Passive investment income includes royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities to the extent of gains therefrom. The term interest is specified by the regulations to include any amounts received for the use of money including tax exempt interest. The exact wording of the Code is noteworthy:

> "For purposes of this paragraph, the term 'passive investment income' means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or

> exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Gross receipts derived from sales or exchanges of stock or securities for purposes of this paragraph shall not include amounts received by an electing small business corporation which are treated under §331 (relating to corporate liquidations) as payments and exchange for stock where the electing small business corporation owned more than 50% of each class of the stock of the liquidating corporation."

The termination of election based on such occurrences is effective for the taxable year of the corporation in which the events occur causing the termination and for all succeeding taxable years of the corporation.

The corporation, once Subchapter S status has been terminated, may not make a new valid election for any taxable year prior to its 5th taxable year after that first taxable year for which such termination was effective unless consent is obtained from the Commissioner. The corporation bears the burden of establishing the relevant facts justifying the Commissioner's consent to a new election.

Passive investment income includes interest. It is noteworthy that in computing the 20%, interest is not offset against the expense of generating interest. In Llewellyn v. Commissioner, 70 T.C. 370, No.33, D. 35, 177 (1978) the tax court addressed the issue "whether interest expense may be netted against interest income for purposes of computing the three thousand dollars passive investment income exception found in §1372(e)(5)(B)(2)(i). In this case the petitioner entered into a long term lease requiring a escrow deposit of $180,000 dollars in a bank account. The deposit produced interest income in excess of the $3,000 limit for the first two taxable years of the corporation. The IRS disallowed Subchapter S status due to passive investment income. The court upheld termination of Subchapter S status and held "that interest expense may not be netted against interest income for purposes of §1372(e)(5)(B)."

Further noteworthy is the fact that the IRS has consented to a new Subchapter S election before the end of the 5 year waiting period in situations where interest income caused termination of the Subchapter S status. In Rev. Rul. 78-275, 1978-2 C.B. 221, a

Subchapter S corporation was engaged in development and subdivision of land. Because of depressed conditions of the economy, the corporation had no income from its operations; however it did receive a small amount of interest from a time deposit it was require to maintain under a credit agreement. This interest constituted a passive investment income which caused the Subchapter S election to terminate. The IRS ruled that the 5 year waiting period for new election did not apply since the receipt of excessive passive investment income was not reasonably within the control of the corporation or its shareholders having a substantial interest in the corporation. In IRS Letter Ruling 7932063 a corporation was formed to participate in the building and operation of a hotel. Due to a strike the opening of the hotel was postponed so that the corporation received no receipts from business. The corporation did receive, however, interest which consituted passive investment income terminating Subchapter S status. The IRS ruled that termination was not reasonably within the control of the corporation or its shareholders and was not part a plan to terminate the election; therefore, the IRS consented to a new election prior to the five year waiting period. In IRS Letter Ruling 7741019, a corporation engaged in selling real estate had no sales income due a slump in the real estate market. For that year, however, it had interest which constituted passive investment income terminating the Subchapter S election. The IRS again determined that the passive investment income was not reasonably within the control of the corporation or its shareholder and therefore a new election prior to the five year waiting period was allowable. In IRS Letter Ruling 7846017, the IRS made a similar determination based upon excessive receipt of interest.

Thus, we find the Internal Revenue Service attempting to give relief in these situations, but the Internal Revenue Service cannot give the relief needed because the election is terminated and then a new election must be made upsetting the entire tax situation for the corporation and its stockholders.

The relief should be a Congressional Act eliminating the 20% rule under Internal Revenue Code §1372(e)(5), effective for corporations with taxable years ending on December 31, 1982 or in the year 1982. Relief is needed for this current year because the unstable economy has created a number of situations involved deposits received or placed in reserve before construction can begin.

Current effective measures are imperative for the construction industry. Many are faced with dire tax consequences because of delays in construction.

Respectfully submitted,

EVANS, PETREE, COBB & EDWARDS

Charles P Cobb

Charles P. Cobb

CPC/sgb

STATEMENT OF THE
INTERNATIONAL COUNCIL OF SHOPPING CENTERS
ON THE
SUBCHAPTER S REVISION ACT OF 1982
SUBMITTED BY
WALLACE R. WOODBURY
TO THE
COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE

SEPTEMBER 10, 1982

The International Council of Shopping Centers (ICSC) respectfully submits the following testimony on S. 2350, the Subchapter S Revision Act of 1982.

ICSC is the trade association for the shopping center industry, with approximately 10,000 members including developers, retailers, lenders, builders, architects and all others having a professional interest in the shopping center industry. This industry consists of approximately 22,000 shopping centers in the United States employing more than 5.9 million persons and conducting approximately 40% of the retail business in the United States.

ICSC supports the enactment of S. 2350 as a major step in simplifying the tax law and eliminating unnecessary technical requirements. The original purpose of Subchapter S was to offer small business the opportunity to obtain the non-tax advantages of incorporation (primarily limited liability) without having to pay a corporate income tax. It was thought that small businesses should have the freedom to select the form of organization which best suited its business needs without regard to tax consequences.

Unfortunately, this worthwhile purpose has been somewhat vitiated because the Subchapter S election and continuing qualification has become encumbered by numerous technical requirements which do not serve any legitimate purpose of the tax law. S. 2350 eliminates many of these unnecessary technicalities and achieves a desired simplification of Subchapter S status. This will allow much greater flexibility for small businesses wishing to take advantage of the corporate form of business without encountering the technical problems and pitfalls of the current Subchapter S requirements.

The proposed expansion of shareholder eligibility requirements, the passthrough of the character of income and deduction items and the elimination of the passive investment income restrictions (except where the corporation has accumulated earnings and profits) will greatly expand or increase the number of taxpayers to whom the corporate form of organization will be available. The elimination of disputes on these items will simplify the administration of the tax law and free revenue agents for more productive activities.

The elimination of distinctions in planning between corporate and partnership forms of doing business is a worthy objective. Because current law encourages the conduct of business in the partnership form, needless complexity and confusion has been introduced to the law of partnerships. The simplification of the Subchapter S rules in S. 2350 is an important step in removing tax considerations from the choice of form or organization for small businesses. We urge the Committee to consider further changes that will remove the obstacle of accumulated earnings and profits from the transformation of a Subchapter C corporation to a Subchapter S corporation.

September 9, 1982

The Honorable Robert Dole
Chairman
Senate Finance Committee
Room 2213
Dirksen Building
Washington, D.C. 20510

Dear Senator Dole:

We wish to express our enthusiastic support for the Subchapter S Revision Act of 1982. The provisions of the Act are consistent with the original intent of Subchapter S and are long overdue.

We endorse the concept expressed during the House Subcommittee Hearings that, subject to limitations, the distribution of accumulated earnings and profits be treated as a long-term capital gain. The Act presently provides that accumulated earnings and profits need not be distributed to qualify as an S corporation. However, to prevent an inadvertent termination, a corporation with passive income should consider distributing its accumulated earnings and profits. The capital gain treatment will reduce the tax burden of distributing accumulated earnings and profits. This should encourage more corporations to incur the tax in order to come within the simplified S corporation rules and will eliminate inadvertent terminations resulting from excessive passive income.

Enclosed for your consideration is a proposed amendment to Section 1368 which provides for capital gain treatment on the distribution of accumulated earnings and profits by an S corporation. The amendment addresses the issues of the form and timing of the distribution and the tax payment. It is designed to simplify accounting procedures and to limit capital gain treatment.

The following is a summary and explanation of the provision of the amendment:

1. In order to be treated as long-term capital gain the entire accumulated earnings and profits must be distributed within one taxable year. This requirement will simplify the accounting required to track accumulated earnings and profits.

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2. The distribution of accumulated earnings and profits must be in cash. This will simplify accounting and eliminate the need to determine the fair market value of property.

3. To prevent shareholders from shifting from C to S to bail out accumulated earnings and profits at capital gain rates and then returning to Subchapter C, the amendment contains two provisions:

(a) Capital Gain Treatment Can Occur Only One Time -

The amendment provides that the accumulated earnings and profits must be distributed during a taxable year beginning before January 1, 1985; otherwise, the distribution is treated as a dividend. The Act already provides that a corporation cannot elect to be an S corporation for five (5) years after termination. Since the January 1, 1985 deadline for capital gain treatment would have passed before the expiration of the five-year period, the capital gain treatment could not be used a second time.

(b) The Advantage of Capital Gain Treatment is Eliminated If Early Termination Occurs -

The amendment provides that if the S election is terminated within five (5) years of the distribution of accumulated earnings and profits which was treated as long-term capital gain, then at the time of termination the shareholders are taxed on sixty percent (60%) of the distribution at ordinary income tax rates plus interest from the date of the distribution. Thus, early termination of the S election results in the distribution being fully taxed as ordinary income (40% at the time of distribution and 60% at the time of termination).

We believe that this amendment is consistent with the intent of the legislation.

We hope you agree that this amendment improves the Act and would appreciate your support.

Very truly yours,

Marvin R. Blumberg
Chairman of the Board

MB/ms
Encl.

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September 10, 1982

Robert E. Lighthizer, Esquire
Chief Counsel
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Subchapter S Hearings

Dear Mr. Lighthizer:

It is respectfully requested that this letter be included in the record of the hearing on the Subchapter S Bill scheduled for September 13 as if I had appeared at the hearing and testified substantially as follows:

My name is John B. Huffaker. I am a partner in the law firm of Pepper, Hamilton & Scheetz with my principal office at

2001 The Fidelity Building
Philadelphia, PA 19109
215-893-3067

We are submitting this statement to urge clarification of the definition of a "qualified subchapter S trust." We feel that extension to the trust described in §1371(g)(3) is very constructive. Subchapter S is already assuming a much more important role in small business planning.

Our focus is on the large number of existing trusts that hold stock in closely held corporations and whose ability to qualify is not clear. We believe these trusts should be able to qualify when the basic statutory concepts are satisfied. Specifically, I refer both to trusts in which there is a potential for multiple income beneficiaries following the termination of the interest of a single income beneficiary and to trusts with the potential for multiple principal beneficiaries following the termination of the interest of a single income beneficiary.

1. Trusts with Potential Multiple Income Beneficiaries.

A common trust is one designed to hold stock until age 21 and then to distribute the principal to the income beneficiary either immediately or upon his exercise of a withdrawal right. Typically, these trusts give the beneficiary a general power of appointment (to meet the definition of §2503(c)) in case of premature death. Since the general power of appointment could be exercised in further trust to name multiple income beneficiaries, there is a potential for future multiple income beneficiaries.

Another common trust is to provide income for life and, at the death of the income beneficiary, to distribute principal among his issue. The share of a child under age 21 would be held in trust until he reaches 21. If he dies before reaching 21, his share goes to his siblings. If two children aren't 21 at the first income beneficiary's death, there will be multiple income beneficiaries.

In each of these common forms of trust, there is a potential for multiple income beneficiaries. In many of these cases, however, there will, in fact, be only a single income beneficiary and, at the conclusion of the income interest, there will be an outright principal distribution -either to the beneficiary, if he has attained the required age, or (for a life income interest) to the income beneficiary's children if they have attained the required age. In these cases, there clearly would be only one income beneficiary throughout the term of the trust but, at the same time, there would be a possibility of future multiple income beneficiaries. Thus, the terms of the trust would not "require" that there be only one income beneficiary.

The mere possibility of future multiple income beneficiaries, however, does not contravene the statutory policy since it is clear who is entitled to income so long as there is only one income beneficiary. In view of this, these trusts should be permitted to elect qualified Subchapter S trust status.

One possible solution is to treat the trusts as qualifying initially and then to treat the trusts as ceasing to qualify if the trust terms are thereafter inconsistent with the trust qualifying. We suggest that if a trust ceases to qualify, there be a brief period to dispose of the stock without ruining the election.

2. Trust with a Potential for Multiple Principal Beneficiaries.

In most non-charitable trusts there is a potential for multiple remaindermen even if there is no potential for multiple income beneficiaries. Any trust which provides for an outright principal distribution to a class (typically the income beneficiary's issue) at the conclusion of an income term creates the potential problem that the multiple remaindermen might be regarded as multiple income beneficiaries. Any such trust must continue for some period necessary for the prudent winding up of the trust and distribution of assets among the remaindermen. This may be no longer than a month but often will be much longer. During this period pending distribution, the income will be paid to (or held for distribution to) the remaindermen who could thus be characterized as multiple income beneficiaries.

The suggested solution for this very common situation is to regard the term "income beneficiary" as not including a person with a vested interest in the principal. This is consistent with normal usage of the term. During this period, each remainderman would be treated as an owner under §678 of his share of the principal or the trust could be treated as the owner.

3. Additional Problem with Capital Gain Distributions Allocable to Corpus.

A different sort of potential problem is presented when the qualifying trust is a simple trust. It is the usual practice of Subchapter S corporations to distribute sufficient income so that the beneficiary will have the funds to pay his taxes. Let us assume that a corporation sells a major asset and distributes 20% of the proceeds to its shareholders. It is unclear whether such a distribution by the corporation could be allocated by the trustee to "income" as distinguished from adding it to "principal." If the latter occurs, the income beneficiary does not have the funds to pay the tax.

It is suggested that a provision similar to §2206 be added giving the beneficiary rights to contribution similar to that given an executor when he must pay estate taxes on life insurance proceeds. Of course, if the corporation does not make a distribution, the beneficiary is stuck. The problem is not limited to trusts making Subchapter S elections but has application to other trusts, such as Clifford trusts.

Conclusion

The attention of the Committee to these matters is greatly appreciated. While we believe that the most pressing problems can be handled through the interpretation of the existing language, there is a great virtue in having statutory certainty at the earliest possible date.

Respectfully submitted,

John B. Huffaker

John B. Huffaker

JBH/bmacc

Hearing of the
Senate Finance Committee,
September 10, 1982,
on S. 2350,
The Subchapter S Revision Act of 1982

Written Statement of
Michael R. Levy

As a result of the tax rate reductions contained in the Economic Tax Recovery Act of 1981, small business corporations that had terminated Subchapter S elections in reliance on the pre-ERTA tax rates will be caught in the trap of the five-year restriction on renewing their elections. In order to correct the unintended adverse effect of ERTA on these taxpayers' reasonable expectations, the Subchapter S Revision Act of 1982 (S. 2350) should include provisions to permit Subchapter S corporations that revoked or terminated their elections prior to the enactment of ERTA to restore their Subchapter S status without penalty. In order to accomplish this, there are attached two proposed amendments to S. 2350 that would have the following effects:

1. The restriction in Code § 1362(g) which would prohibit re-election of Subchapter S status (without the consent of the Secretary within five years of of the termination or revocation of such an election) would be modified by a new subsection (h) that would allow a corporation whose Subchapter S election was terminated or revoked by reason of an event occurring prior to

the enactment of ERTA to re-elect Subchapter S status without the consent of the Secretary for its first taxable year ending after December 31, 1982.

2. As a corollary of the foregoing proposed amendment, the restriction in § 1374(c) (which would generally impose a corporate tax on capital gains recognized by an S corporation where the election had not been in effect for the immediately preceding three consecutive years) would be modified to permit a corporation that re-elects Subchapter S status under the re-election provision proposed above to disregard for purposes of § 1374(c) the consecutive years immediately prior to re-election during which it was not an S corporation.

Consistent with the foregoing, if S. 2350 were modified to impose a tax on the earnings and profits of a corporation at the time it elects to become an S corporation, it would be appropriate to provide an exception for corporations that avail themselves of the re-election provision proposed in paragraph 1 above in order not to deny shareholders of such corporations the relief intended by that provision.

Explanation of Proposed Amendments

1. Section 1362(h) Re-Election Provision.

One of the legitimate and intended purposes of Subchapter S is to allow the owners of a closely-held corporation to choose the less costly option of being taxed like a partnership while continuing to operate their business in the corporate form. Tax Recommendation No. 16, Budget Message of January 21, 1954, 100 Cong. Rec. 571 (1954), reprinted in 1954 U.S. Code Cong. & Admin. News 1567. The existing restriction on re-election of Subchapter S status within five years of termination or revocation of an election (which, under S. 2350, would be re-enacted as section 1362(g)) was not intended to limit the availability of tax savings through Subchapter S in all cases; it was intended to prevent Subchapter S from being used as a tax avoidance device by corporations that would elect in and out of Subchapter S depending on their earnings and losses from year to year. See S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958), reprinted in 1958 U.S. Code Cong. & Admin. News 4878.

With the passage of ERTA, the maximum individual tax rate was lowered from 70% to 50%. As a direct result of that change, corporations that now find that tne provisions of Subchapter S will afford a tax savings have made or will make elections accordingly. However, corporations that terminated their Subchapter S elections after 1978, when the pre-ERTA tax rates may have made continuation of Subchapter S status unattractive, are currently prevented and would continue to be prevented by proposed § 1362(g) from re-electing Subchapter S status now and gaining the benefit of the reduced ERTA tax rates.

There is no reason to suppose that the benefit of Subchapter S should be more available to corporations that have never before made a Subchapter S election than to corporations that terminated or revoked their elections only to find Congress thereafter recreating through tax cuts the benefit to them of their former Subchapter S status. To maintain the restriction on new elections by these corporations does nothing to further the policy against tax avoidance which underlies the five-year restriction on re-election. The attached amendment to § 1362 would permit a one-time only exception to that restriction in order to permit corporations that failed to anticipate the ERTA tax cuts to restore their Subchapter S status.

2. Section 1374(c) Capital Gains Provision.

The purpose of the existing capital gains tax on corporations whose elections are less than three years old (which, under S. 2350, would be re-enacted as Section 1374(c)) is to prohibit anticipatory elections, whereby a corporation could deliberately elect Subchapter S in a year when it anticipates realizing large capital gains. S. Rep. No. 1007, 89th Cong., 2d Sess. 1 (1966), reprinted in 1966 U.S. Code Cong. & Admin. News 2146. By hypothesis, this is not a legitimate concern with respect to those corporations that would be eligible to re-elect Subchapter S status under the foregoing proposal. Consistent with the desire to permit these corporations to restore their prior status as S corporations, it would be unfair to subject such corporations to the burden of capital gains taxes for three years subsequent to their re-election solely on account of the fact that they terminated their elections in reliance on the then-existing tax rates. This would be avoided by the attached amendment to proposed § 1374(c).

3. Modified Tollcharge Provision.

There is under consideration an expansion of S. 2350 that would subject the shareholders of a newly-electing S corporation to taxation on the accumulated earnings and profits of the electing corporation. As a corollary to the preceding two proposals, if such a provision is added to S. 2350, it should not be made applicable to those corporations for which the foregoing relief provisions are intended. The purpose of such relief is to permit corporations that failed to anticipate ERTA tax rate cuts to restore their status as S corporations and thereby eliminate the unanticipated adverse consequences of the earlier revocation or termination. It would be altogether inconsistent with that purpose to subject those corporations to this new impediment to making a Subchapter S election.

Conclusion

The stated purpose of S. 2350 is to make it both easier and simpler for a corporation to elect to operate under Subchapter S by revising provisions "that tend to create traps for the unwary." The restrictive features of Subchapter S as proposed in S. 2350 and discussed *supra* are intended to prevent corporations from using Subchapter S as a tax avoidance device. As a result of ERTA, however, small business corporations that relied on the provisions of the Internal Revenue Code and that were not seeking to manipulate the tax laws by electing in and out of Subchapter S will nonetheless be caught in the trap of the three-year and five-year restrictions and the suggested tollcharge provision. The remedies proposed in these comments are very narrow, one-time-only corrections. If the amendments to S. 2350 suggested herein are adopted, an unintended tax burden will be eliminated without in any way eviscerating the intended inhibitory effect of the restrictive provisions on manipulative practices.

Respectfully Submitted,

Michael R. Levy

PROPOSED AMENDMENTS TO S. 2350 TO ELIMINATE UNINTENDED EFFECT OF ERTA TAX RATE REDUCTIONS

1. Add Section 1362(h), as follows:

"(h) EXCEPTION. -- Notwithstanding the requirements of subsection (g), in the case of a small business corporation that made an election under section 1372(a) (as in effect before the enactment of the Subchapter S Revision Act of 1982) which was terminated or revoked by reason of an event that transpired after January 1, 1979 but before August 18, 1981, such corporation shall be eligible to make an election under subsection (a) (without regard to the limitations contained in subsection (b)) for its first taxable year ending after December 31, 1982.

2. Add at the end of Section 1374(c)(1) as follows:

"For purposes of this paragraph, in the case of an S corporation that made an election under section 1362(a) pursuant to the provisions of section 1362(h), the consecutive taxable years during which such election was not in effect immediately preceding the 1st postenactment year shall be disregarded."

STATEMENT OF
BERNARD M. (BOB) SHAPIRO
NATIONAL DIRECTOR OF TAX POLICY
PRICE WATERHOUSE
REGARDING
THE SUBCHAPTER S REVISION ACT OF 1982 (S. 2350)
SEPTEMBER 10, 1982

In my capacity as the National Director of Tax Policy for Price Waterhouse I am submitting this statement to express our strong support of the legislation to revise Subchapter S of the Internal Revenue Code.

This is an area in which I had a personal involvement during my 15 years with the staff of the Joint Committee on Taxation. I think it would be helpful background for me to summarize the consideration of the revisions to Subchapter S during this period. Our statement covers two areas: first, an overview of the revision process and, second, some comments on possible areas for change. This statement includes comments on issues suggested by Chairman Dole in his press release announcing the Finance Committee's September 10 hearing on S. 2350. It does not address all of the bill's provisions, since the firm generally supports the legislation and understands the various considerations that entered into some of the decisions which are in the proposed legislation.

Price Waterhouse would like to strongly urge the Committee to consider and complete action on this legislation needed by practitioners and businesses. It clarifies the law to make the tax code more workable and eliminates certain inadvertent traps that were not intended by the original legislation.

It would be all too easy to defer action until the next Congress in an effort to try to work out all the differences. Any time you deal with a major area, there are quite naturally different views on specific provisions. It is a rare piece of legislation that receives total support for all provisions. The process by which the current Subchapter S simplification bill was developed, and the proposal itself, have gained the support of practitioners and businesses; if Congress delays action on this bill it could jeopardize the collegial process whereby practitioners and businesses join with the Congressional tax-writing committees to simplify the tax code in the future.

I. BACKGROUND OF TAX SIMPLIFICATION PROCESS

In 1977 when Laurence N. Woodworth became the Assistant Treasury Secretary for Tax Policy and I succeeded him as the Chief of Staff of the Joint Committee on Taxation, our respective staffs met with both the majority and minority staffs of the House Ways and Means Committee and the Senate Finance Committee to initiate a process for simplification. Various staff members then met with the Chairmen and ranking members of the tax subcommittees of the respective committees, to discuss and receive their approval for these staff initiatives.

We started out with a series of small and minor changes to the tax code to initiate the process. This went very smoothly, with strong support from the members' staffs, the Treasury Department, and various professional groups which assisted in the process. The first major effort was the Installment Sales Revision Act of 1980 (P.L. 96-471), which was signed into law on October 19, 1980. This was a limited area of the code, but some of the modifications were controversial and it was the first significant test of the simplification process. It survived and the installment sales legislation was received enthusiastically by the tax committees as a major success for tax simplification.

We next turned our attention to a larger area for simplification -- revision of an entire subchapter. We first focused on the Subchapter S provisions, a project which had been started in the early 1960's.

II. HISTORY OF SUBCHAPTER S REVISIONS

Subchapter S was enacted to deal with the problems of a small business which wanted to incorporate the business entity for legal purposes but preferred to be treated as a partnership for tax purposes. A legal benefit to incorporation is the "limited liability" of the shareholders for the corporation's actions and liabilities. A partner, on the other hand, is generally liable for the actions and liabilities of the partnership, except where certain partners have a special status of "limited" partner. The tax consequences of a corporate structure generally subject the profits of the entity to a double tax: first, at the corporate level and, second, at the shareholder level, as the aftertax profits are distributed as dividends. The tax benefit associated with partnership status is the one level of taxation -- a partnership is merely a conduit through which the tax characteristics of the business are passed through to the individual partners and the income is not taxed at the partnership level.

In the 1950's, Congress was made aware of the concern of small business regarding the difference in the tax treatment depending on whether the business was a partnership or a corporation. It was apparent that an adverse impact existed where a small business wanted to be taxed as a partnership, but also wanted to be formed as a corporation in order to have the legal protection of limited liability to its shareholders. The belief was that there should not be a distinction in the tax treatment of small businesses, whether formed as a corporation or as a partnership. As a result, in 1958 Congress enacted Subchapter S of the Internal Revenue Code, which permits the owners of a business which had incorporated the entity for business and legal purposes to elect to be treated for tax purposes in a similar manner as a partnership.

In its efforts to limit this special classification to small businesses, a major decision had to be made by Congress as to the test to use for size. Many problems existed with a size determination based on gross receipts. Thus, Congress settled on the number of shareholders as a means to determine size. At the outset, Congress limited this special small business election to corporations with 10 or fewer shareholders.

These Subchapter S rules were generally intended to be patterned after the partnership tax rules. Because the entity is a corporation, however, it is a "hybrid" for tax purposes requiring many special and unique rules. It is quite natural that unanticipated problems, which required revisions, became obvious.

In the early 1960's, an effort was initiated by the Treasury Department, in coordination with the Joint Committee staff and the Tax Section of the American Bar Association, to review the Subchapter S provisions to determine how they were working in practice. A number of problems had already surfaced, ranging from inadvertent terminations to basic treatment of the various characteristics of the income, deductions, profits, and losses. In addition, there was a general view that the Subchapter S concept had been accepted and, therefore, some of the more restrictive elements of the 1958 law could be expanded to cover more situations. Periodic meetings of the Subchapter S working group were held over the years. These discussions resulted in a Subchapter S revision package which was included in the Treasury Department's tax reform studies released at the end of the Johnson Administration.

In 1969, when Congress considered tax reform, Subchapter S changes were on the initial agenda of the House Ways and Means Committee. However, the effort for tax reform covered so many areas that when Subchapter S came before the Committee, it appeared too massive an area for consideration at that time. It subsequently was deferred except for one very major tax change that was adopted by the House Ways and Means Committee and ultimately enacted into law. The "H.R. 10 pension limitations," which applied to partnerships, were extended to shareholders of Subchapter S corporations in lieu of the more liberal pension rules for corporations generally. The H.R. 10 pension limitation was considered by the working group as a "tradeoff" for some of the expanded areas of Subchapter S, including the repeal of the passive income limitation. None of the other provisions was enacted, however.

During the 1970's, in the various tax acts that were passed, a few provisions were enacted that were contained in the Subchapter S proposals of the Treasury Department in addition to other needed revisions. Also, the Economic Recovery Tax Act of 1981 (P.L. 97-34) expanded Subchapter S corporation size to the present level of 25 shareholders. However, the major revisions involving the more detailed modifications of Subchapter S which would make it more workable and easier to understand were not considered because of time constraints.

In 1980, the Joint Committee on Taxation staff published a document setting forth all of the proposed revisions that appeared to have a consensus at that time from those working on Subchapter S changes. There was an effort to have a bill drafted then but, because of the demands of other tax legislation, the drafters were unable to do so. Price Waterhouse is pleased that one of the major accomplishments of the Congressional staffs in the simplification areas has been their perseverance to go forward with the drafting of a bill. This effort required a great deal of support from many staffs, including the Senate Finance Committee, the House Ways and Means Committee, the Joint Committee on Taxation, the Treasury Department, and the Tax Sections of the American Bar Association and the American Institute of Certified Public Accountants. We especially want to commend the efforts of the Legislative Counsel's Office in the actual drafting process.

While Price Waterhouse is well aware that not everyone supports all of these provisions and that several items have been left open for further consider tion, we want to again strongly urge the Committee to utilize every means possible to enact a Subchapter S revision bill during this Congress. This proposal did not just appear this year. Rather, it is a process that has been going on for almost 20 years with a tremendous amount of time and effort contributed by a countless number of people. The bill represents a major simplification effort and is an appropriate expansion of the use of Subchapter S. It benefits not only the practitioner who must apply the law but also small businesses that would like to take advantage of these rules.

III. COMMENTS ON SPECIFIC PROVISIONS

Although we believe that, on balance, the proposed legislation is a substantial improvement over current law, several key issues are still in question. Rather than critiquing all of the provisions of the legislation, we will confine our remarks to these issues, addressing only those points on which you have requested comments and touching upon some other points we believe especially relevant.

Election of Subchapter S by Regular Corporation

Under present law, the Subchapter S election may be made by a regular corporation without any immediate tax effects to either the corporation or its shareholders. The earnings which accumulated prior to the Subchapter S election are preserved and taxed as dividends when distributed to the shareholders. Conversely, when a corporation liquidates and then continues to conduct business in partnership form, present law does not allow the deferral of shareholder tax even though the same individuals who were shareholders are now partners. The basis of the corporation's assets to the partnership is then increased to fair market value.

Because S. 2350 provides Subchapter S corporations with more partnership-like treatment, the question has been raised as to whether a "toll charge" should be enacted for regular corporations electing Subchapter S status similar to the treatment of corporations converting into partnerships.

When the staff considered this issue in its 1980 study, it decided not to change existing law in this area. However, the reaction and comments that were received by the staff led them to believe that possible "gamesmanship" could be practiced in certain cases by shifting from corporate status to Subchapter S status, without a toll charge. In view of this, discussions took place to resolve this potential abuse. This issue has been left open in the bill before the Committee; without some action by Congress existing law would continue. This is the major issue on which comments were requested.

Price Waterhouse understands the concerns regarding the possible manipulation that could occur if Congress continues existing law in this area. Proposals have been advanced to develop a special toll charge on an elective basis for corporations which have accumulated earnings and profits (E&P). This election would eliminate the taint associated with those corporations electing Subchapter S treatment. However, we are aware that this type of proposal has some strong critics regarding

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other associated implications and complexities, and expect these points of view to be fully developed in the testimony before the Committee.

The House Ways and Means Select Revenue Measures Subcommittee rejected the toll charge concept, and Price Waterhouse fully supports its decision.

Passive Income Limitation

Under present rules, a Subchapter S election is terminated for any taxable year in which the corporation's income from passive-type investments exceeds 20 percent of gross receipts. The purpose of a passive income limitation was to make Subchapter S status available only to corporations engaged in active trades or businesses and to prevent taxpayers from incorporating investment activities and electing Subchapter S status in order to benefit from the corporate pension plans.

The passive income limitation has caused many inadvertent disqualifications of Subchapter S elections, in addition to a substantial amount of disputes regarding the definition of what constitutes passive income. The bill would continue this rule for corporations with accumulated E&P. Effectively, the bill would exempt from the passive income test only corporations formed after the effective date of the bill and electing Subchapter S treatment immediately.

The Committee should consider eliminating E&P from corporations if the E&P was accumulated subsequent to their Subchapter S election. Such action would make existing Subchapter S corporations, which had immediately elected Subchapter S treatment at the formation of the corporation, not subject to the passive income limitations. Additionally, if a corporation has no accumulated E&P prior to its Subchapter S election, it would not be subject to the passive income limitations.

In cases where the limitation is to be retained, it would appear appropriate to raise the maximum allowed level of passive income from 20 percent to possibly 50 percent. In this way, the potential situations which could be considered abusive would be covered. Additionally, the situations under present law which are clearly inadvertent violations of the restrictions would most likely be relieved from termination penalties.

One Class of Stock Requirement

Under present law, a Subchapter S corporation is barred from having more than one class of stock because of the complexities involved in allocating income and losses to a second class of stock. The bill would allow differences in the voting rights in the Subchapter S corporation's common stock.

In certain situations, a purported debt instrument could be reclassified as stock. The courts have allowed certain instruments to exist under present law because no tax avoidance possibilities were available, even though the debt would normally be considered equity for tax purposes. The IRS has indicated that it will not litigate cases factually similar to these judicial precedents. It appears obvious, therefore, that the courts have taken a very reasonable and practical approach in dealing with the debt vs. equity issue as it relates to Subchapter S corporations.

The House Ways and Means Select Revenue Measures Subcommittee amended its version of the bill to provide that a corporation's Subchapter S election would not be terminated if the corporation has a "safe harbor" outstanding straight-debt instrument -- a written unconditional promise to pay on demand or on a specified date a sum certain in money, with a fixed interest rate, which is not convertible into stock -- which is held by a person who is eligible to hold Subchapter S stock. For an instrument which does not qualify under the safe harbor, a determination of whether it is a second class of stock would be made

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under generally applicable tax procedure. Price Waterhouse supports the subcommittee's action.

Foreign Source Income Limitation

Presently, a Subchapter S election is terminated for any taxable year during which the Subchapter S corporation's gross receipts from foreign sources exceed 80 percent. The bill would continue this rule.

The legislative history of Subchapter S does not clearly indicate why the foreign source income limitation was enacted. Furthermore, the 1980 study recommended repeal of the foreign source income limitation. This recommendation was in part due to the lack of legislative history on the restriction and the fact that Subchapter S shareholders are taxed currently on the corporation's earnings from both domestic and foreign sources. In addition, the 80-percent limitation provides, at best, only a minimal level of restriction.

The House subcommittee repealed the foreign source income test in its version of the Subchapter S simplification bill. The subcommittee also amended the bill to provide that a Subchapter S corporation should be treated as a partnership for purposes of foreign source income. Price Waterhouse supports both changes.

Affiliated Groups

Under present law, a member of an affiliated group of corporations is not eligible for a Subchapter S election. In other words, a corporation that elects Subchapter S status cannot own 80 percent or more of the stock of another corporation unless such corporation is inactive. The bill would retain this rule regarding affiliated groups.

Due to the bill's substantial modifications to the Subchapter S rules, it is expected that a significant number of corporations who are members of an affiliated group will consider a Subchapter S election. In addition, because the bill allows corporations a two-and-one-half-month "look-back" period in which to decide whether to elect Subchapter S, there is a problem with the interaction of the consolidated return regulations with the qualification rules of Subchapter S. For example, assume a calendar year parent company filing a consolidated return wants to liquidate its wholly-owned subsidiary within the two-and-one-half-month period in order to elect Subchapter S status. Also assume that the liquidation occurs on March 1 of the group's tax year. Because the subsidiary is required to be included in a consolidated return for the two months of January and February, the parent corporation is prevented from electing Subchapter S until the following calendar year, even though on the date the

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election is required the parent corporation is no longer a member of an affiliated group.

Price Waterhouse feels that any legislation revising the Subchapter S rules should either modify the Subchapter S affiliated group rules to provide an exception or allow affiliated groups to elect to "disaffiliate" in order to file separate returns for the short tax year in order to qualify for the Subchapter S election.

We would like to thank the Finance Committee for allowing us the opportunity to present our view on this important legislation to simplify the Internal Revenue Code.

COMMENTS
OF
THE NATIONAL ASSOCIATION OF MANUFACTURERS
ON S. 2350
SUBMITTED TO THE
COMMITTEE ON FINANCE
U. S. SENATE
SEPTEMBER 10, 1982

The National Association of Manufacturers welcomes the opportunity to submit comments on S. 2350, the Subchapter S Revision Act of 1982. The National Association of Manufacturers represents over 11,000 member companies, 80 percent of which have less than 500 employees.

The National Association of Manufacturers commends this Committee for its efforts to revise and simplify Subchapter S. However, we recommend modification of the following provisions relating to the eligibility and operation of Subchapter S corporations:

A. PASSIVE INVESTMENT INCOME LIMITS

Present law terminates Subchapter S status for a corporation with more than 20 percent of gross receipts in passive income in any taxable year. S. 2350 amends current law by eliminating this test for Subchapter S corporations with no accumulated earnings and profits and for new Subchapter S corporations. However, an exception still exists which applies the passive investment income restriction to Subchapter S corporations with substantial accumulated earnings and profits.

The National Association of Manufacturers recommends complete elimination of the passive income limitation. There are several compelling reasons which support our position. First, it is often difficult for small businesses to differentiate between "passive" and "active" income, and to determine when the 20 percent limit has been met. Even those businesses with sophisticated accounting systems have difficulty defining "passive" income.

Secondly, numerous disqualifications have occured among small businesses as a result of the difficulty in distinguishing between types of investment income. These corporations have inadvertantly surpassed the permissible level of passive income. Termination of Subchapter S status is retroactive to the beginning of the taxable year and a five year period must lapse before a new Subchapter S election can be made. These restrictions counterbalance the benefits that Subchapter S status is intended to afford small business.

An additional reason for eliminating the passive income test is that it serves no revenue purpose. Strict limitations on qualified corporate retirement plans and the reduction in individual passive income tax rates have eliminated the revenue need for this test. Also, due to the restriction on passive income, an existing Subchapter S corporation is in the position of having to distribute its earnings with the risk that if it distributes too much, it will be forced to operate with low capital resources. If a corporation distributes too little, its Subchapter S status will be revoked.

Further support for dilution of the passive income test is proposed in an amendment to H.R. 6055, the House version of the Sbuchapter S Revision Act of 1982. In mark-up on June 23, 1982, the House Ways and Means Subcommittee on Select Revenue Measures approved an amendment which would exclude additional items from the definition of "passive investment income". We recommend that this Committee carry this one step further and completely eliminate this burdensome restriction.

B. TREATMENT OF DISC/FOREIGN SUBSIDIARY

Current law precludes a domestic corporation from electing Subchapter S status if it is a member of an affiliated group as defined in Internal Revenue Code Section 1501. However, an exception exists which allows an affiliated member to own a DISC, foreign subsidiary or inactive active subsidiary without losing its Subchapter S election, assuming the other eligibility requirements are met.

Under proposed Internal Revenue Code 1361, a member of an affiliated group is still ineligible for Subchapter S status. However, unlike current law, the proposed language provides an exception to I.R.C. Section 1501 for domestic corporations which own an inactive subsidiary. The current exception for foreign subsidiaries and DISCs is not included. Therefore, corporations which currently are permitted to own a foreign subsidiary or DISC without termination of their election are now forced to terminate their Subchapter S election.

We recommend that the exception to an affiliated group which exists under current law for DISCs and foreign subsidiaries be retained in S. 2350. Inclusion of a DISC/foreign subsidiary as a member of an affiliated group is an unnecessary change which would unfairly discriminate against existing Subchapter S corporations which heavily rely on this exception.

If this Committee should decide to retain this provision which denies exceptions for DISCs/foreign subsidiaries, then the effective date should be modified so that it does not discriminate against those entities which have taken affirmative steps towards Subchapter S election. Under proposed Section 1379 (a), entitled Transitional Rules on Enactment of the proposed bill, any election made under prior law regarding Subchapter S status shall be treated as an election made under the amended law. Thus, if a domestic corporation has elected Subchapter S status for 1982, it would be permitted to maintain its status in 1983 and thereafter, even though it took no action to divest itself of its foreign subsidiary or DISC subsidiary. The bill, as currently drafted, prohibits a domestic corporation with DISCs/foreign subsidiaries from electing Subchapter S status for 1983 and thereafter, even though a similar fact pattern would have allowed Subchapter S status just one year earlier. While these transitional rules protect existing Subchapter S corporations, we believe that there has not been proper notice to those entities who have made substantial progress towards an election for next year. We urge the Committee to adopt an effective date of one year from the date of enactment so as to give all interested parties the benefit of adequate notice.

An alternative approach which the National Association of Manufacturers also favors, would be to allow domestic corporations which maintain foreign subsidiaries or DISCs to elect Subchapter S status as long as the DISC/foreign subsidiary has maintained an active trade or business for a specified period of time, such as three or five years. This approach has the advantage of not coercing the taxpayer into choosing between either Subchapter S status or ownership of a DISC or foreign subsidiary.

C. FOREIGN INCOME LIMIT

Under current law, no more than 80 percent of a corporation's gross receipts can be from sources outside of the United States. S. 2350 fails to address this provision. We urge this Committee to repeal this restriction and adopt an amendment which repeals the 80 percent foreign income test so that all of a

Subchapter S corporation's income can be derived from foreign sources. Opportunities for tax avoidance are effectively restrained by Subchapter N, and there is no reason for continuation of this limitation.

D. TAXABLE YEAR

The proposal that a Subchapter S corporation must use a calendar year for accounting and tax purposes could add great complexity for many companies. If a corporation not currently on a calendar year basis elects Subchapter S status, there are major difficulties associated with transition to a calendar year basis, particularly if LIFO is being used. These complexities could outweigh the desirability of Subchapter S for many small businesses. Therefore, we recommend that this requirement be repealed.

E. FRINGE BENEFITS

Present law permits Subchapter S corporations to participate in certain fringe benefits for employees, including group life insurance and health and accident insurance. These statutory fringe benefits are the most advantageous of those included in current Subchapter S law. However, under the proposed legislation, partnership rules would be applicable to Subchapter S and any 2 percent or more shareholder would be treated as a partner. We recommend that this provision be repealed, and that statutory fringe benefits presently available to Subchapter S corporations be retained.

In conclusion, the National Association of Manufacturers recognizes the importance of this legislation as a step to alleviating the unnecessary rules and restrictions of Subchapter S. The National Association of Manufacturers supports S. 2350 with modifications, including: complete elimination of the passive investment income limit; the inclusion of exceptions to the definition of an affiliated member for a DISC and foreign subsidiary; repeal of the provisions relating to foreign source limitation; repeal of the use of the calendar year; and retention of existing rules on fringe benefits.

STATMENT OF JAMES R. BRIDGES
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
September 10, 1982

S. 2350: THE SUBCHAPTER S REVISION ACT OF 1982

My name is James R. Bridges. I am a partner in the San Francisco law firm Thelen, Marrin Johnson & Bridges. This statement is submitted on behalf of McNeil Executive Services Company, Sequoia Ventures Inc. and L. E. Wentz Co., clients of the firm.

The proposed Subchapter S Revision Act of 1982 (S.2350/H.R. 6055) (the "Bill") represents a welcome attempt to simplify subchapter S, remove traps for the unwary as well as unintended tax avoidance opportunities which exist under present law, and broaden access to subchapter S. The Bill is extremely well thought out and well drafted and, in general, succeeds admirably in achieving its purposes. The Committee has asked those interested in the Bill to comment with respect to two specific issues (i) the possible application of the "debt-equity" regulations to S corporations, and (ii) the appropriate treatment of regular corporations ("C corporations") with accumulated earnings and profits electing subchapter S status. I will address the second of these issues as well as an additional aspect of the Bill.

I. SUMMARY OF STATEMENT

A. The passive income test should be eliminated in its entirety as recommended by the staff of the Joint Committee on Taxation in 1980. Since its enactment in 1958, subchapter S has never discriminated between S corporations with accumulated earnings and those without. The election of S status is not equivalent to a corporate liquidation nor does such an election provide C corporations with accumulated earnings an ability to avoid tax on those earnings. Retention of the passive income test for such corporations, as the Bill proposes, is unwarranted. Such partial retention of the test would restrict access to subchapter S and perpetuate the confusion and trap for the unwary inherent in present law, thus defeating basic objectives of the Bill.

B. The definition of qualified subchapter S trusts should be expanded to include accumulation trusts. Grantor and similar accumulation trusts are permitted to be shareholders of S corporations under present law. Expansion of the definition of qualified subchapter S trusts to include accumulation trusts would be consistent with the treatment of grantor and similar trusts, would violate no policy, and would further the Bill's objective of broadening access to subchapter S.

II. DISCUSSION

A. Subchapter S Corporations with Accumulated Earnings and Profits.

Subchapter S has been on the books since 1958. In all that time the law, regardless of its other infirmities, has never seen fit to discriminate between S corporations with accumulated earnings and profits ("E&P") and those without E&P, save, of course, that distributions from E&P accumulated prior to a subchapter S election have always been treated as taxable dividends. In particular, the subchapter S election has always been equally available, without penalty or charge, to all corporations--newly formed corporations, existing C corporations without E&P and existing C corporations with E&P.

The Bill would change this. In effect, the Bill would single out electing C corporations with E&P for a penalty to which newly formed corporations and electing C corporations without E&P would not be subject. Under present law, an S corporation loses S status if in any year more than 20% of its gross receipts are "passive income" - dividends, interest, rents, royalties, annuities and gains from sales or exchanges of stock or securities. The Bill would delete the passive income test for all S corporations except electing C corporations with E&P. For such corporations, the test would be retained.[*]

The partial retention of the passive income test would be contrary to the recommendations of the staff of the Joint Committee on Taxation published on April 30, 1980 (the "Staff Report"). The Staff Report pointed out that the principal reason for the inclusion of the passive income test in subchapter S as originally enacted in 1958 was a concern that individuals would "incorporate their pocketbooks" in order to obtain the tax deferral benefits accorded qualified pension and profit-sharing plans. Staff Report, part III, section A.5. This concern has been of little validity since the Tax Reform Act of 1969 and has disappeared entirely with the passage of the Tax Equity and Fiscal Responsibility Act of 1982. The Staff Report also recognized that the deletion of the passive income test is entirely consistent with the purposes of the personal holding company rules, since the shareholders of an S corporation are taxed currently on the corporation's investment income. Staff Report, part III, section A.5.

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[*] The Bill as marked up by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means of the House of Representatives would make the passive income test substantially more onerous than present law as regards gross receipts from the disposition of capital assets and would make special provisions regarding interest on notes acquired in connection with certain sales of inventory and regarding certain lending and finance companies.

The Staff Report, after concluding that there were no policy reasons requiring the retention of the passive income test, went on to state the affirmative reasons for eliminating the test:

> "[The] passive income limitation has caused a number of inadvertent terminations of elections, as well as a substantial amount of litigation as to what constitutes passive investment income. Controversy exists as to whether the term passive investment income includes interest and rents which are earned in the active conduct of a trade or business (e.g., interest of a small loan company or produced film rents of an active production company). Elimination of this restriction would remove much uncertainty, reduce litigation, and prevent retroactive terminations of subchapter S elections." [Staff Report, part III, section A.5.]

The Staff Report concluded with the recommendation that the passive income test be eliminated in its entirety. The Bill, in deleting the test for all corporations except electing C corporations with E&P, properly endorses the reasoning of the Staff Report. Yet the Bill, in its partial retention of the test, proposes to perpetuate the very ills enumerated in the Staff Report.

If the passive income test is retained as the Bill proposes, a C corporation which wished to make the subchapter S election and which had significant E&P would be faced with a dilemma -- whether to effect, in substance, a partial liquidation, thus eliminating E&P, or to run the risk of a subsequent inadvertent termination of S status because of an inability to control the exact mix of its gross receipts or to know with certainty whether each item of those receipts was active or passive for purposes of the test. Moreover, E&P calculations are often complex and difficult -- more so than ever as a result of the Economic Recovery Tax Act of 1981 -- and it is well understood that most small businesses are not the beneficiaries of sophisticated tax advice. A C corporation with no earned surplus, which therefore concluded that it had no E&P and could safely convert to a S corporation, might well find out later that in fact it had E&P and was subject to the test. The trap for the unwary, discussed in the Staff Report and which the Bill would perpetuate, is very real indeed.

In the circumstances it would be legitimate to suppose that some strong policy reason for partial retention of the passive income test has been adduced since the publication of the Staff Report. This, however, is not the case.

The sole rationale for partial retention of the passive income test which has been offered is the following scenario: (i) a C corporation with E&P elects S status; (ii) the assets reflected by E&P are placed in passive investments; (iii) a shareholder receives the current income from such investments subject to only one tax; and (iv) the shareholder dies before E&P are distributed, his stock thus obtaining a stepped-up basis.

Three evils are perceived in this scenario: (i) that to permit a C corporation with E&P to convert to the single tax regime of subchapter S without penalty or charge involves tax abuse; (ii) that there is something inherently pernicious about passive income in the subchapter S context; and (iii) that the nature of an S corporation with both E&P and passive income is such that the stepped-up basis on death rules create a unique tax abuse or tax avoidance opportunity. Each of these evils is illusory.

The reasoning underlying the first perception proceeds along these lines: S corporation status is somewhat akin to partnership status; upon the liquidation of a C corporation with E&P in order to continue the business in partnership form, the shareholders are subject to tax; therefore, tax abuse will result unless a penalty or charge is levied when a C corporation with E&P elects subchapter S.

The analogy to a corporate liquidation simply does not hold up. When a C corporation with E&P liquidates, its shareholders are subject to tax for the very good reason that, as a result, they have the assets of the corporation, including its E&P, at their immediate disposal. This is so whether they retain those assets, sell them, contribute them to a partnership, or otherwise dispose of them. Such assets receive a stepped-up basis on the liquidation. In contrast, under both present law and the Bill, when a C corporation elects S status, all its assets remain in corporate solution, with a carryover basis. Subsequent distributions from E&P remain taxable as dividends, sales of assets result in tax to the shareholders (or the corporation), and the normal rules regarding liquidation continue to apply.

In short, election of S status is not the equivalent of a corporate liquidation. In fact, an election bears only one similarity to a liquidation -- income derived from the subsequent deployment of previously accumulated E&P will be subjected to only a single tax, at the individual level. This, of course, is the basic concept of subchapter S. To take issue with this result would be to exalt double taxation as a policy objective. The elimination of subchapter S, rather than its liberalization, would be in order.

In fact, the proponents of partial retention do not go so far. Instead they shift their attention to passive income. In their view, it would seem, passive income is undeserving of the benefits of the single tax regime of subchapter S. The difficulty with this view is obvious. Subchapter S has never discriminated against passive income as such. As the Staff Report concluded, subjecting passive income to a single tax at the shareholder level is entirely consistent with the purposes of the personal holding company rules. The passive income test was originally included in subchapter S not because of a bias against a single tax on such income but for reasons which are no longer valid. The Bill, in deleting the passive income test for all S corporations except those with E&P, demonstrates that there is no taint on passive income in the subchapter S context.

Accordingly, partial retention of the test must be justified, if at all, by some special tax abuse or avoidance opportunities resulting from the application of the stepped-up basis rules on the death of a shareholder of an S corporation with undistributed E&P.

Whatever else might be said of death as a tax avoidance device, the stepped-up basis rules have nothing to do with E&P, with passive income, or, in fact, with subchapter S. The stock of every corporation -- C or S, with or without E&P, with or without an active business -- receives a stepped-up basis on death. It is ludicrous to suggest that this fact of life (and death) somehow dictates that the passive income test be retained for S corporations with E&P.

Quite obviously, the total elimination of the passive income test would create no unique ability to "forever shelter" E&P from tax at individual rates. There being no tax avoidance opportunity attendant upon complete elimination of the passive income test, why then do the proponents of partial retention of the test wish to deny the benefits of the stepped-up basis rules to the shareholders of S corporations with E&P when those rules would be available to the shareholders of all other corporations (and to all partners in partnerships and all sole proprietors)? Clearly the proponents of partial retention find the stepped-up basis rules objectionable in general. It is the tax avoidance possibilities they perceive to be inherent in the stepped-up basis rules to which they object, not to any peculiar result which would follow from the application of those rules to S corporations with E&P.

The debate between the proponents of carryover basis and those of stepped-up basis has raged for many years and, no doubt, will go on for many more. It is not necessary to argue the merits of either side of the case here. It is sufficient to note that there is no reason whatsoever to single out the shareholders of an S corporation with E&P for a penalty to which taxpayers in general are not subject.

As a result of the passage of the Tax Equity and Fiscal Responsibility Act of 1982, the Bill must be substantially rewritten in any event. As a part of that rewrite Bill §1362(d)(3)* should be stricken in its entirety and the passive income test totally eliminated.

Total elimination of the passive income test will simplify and broaden access to subchapter S as well as removing a trap for the unwary, thus furthering basic objectives of the Bill.

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* References to Bill sections are to sections of subchapter S as it would be amended by the Bill.

Elimination of the passive income test will serve a further purpose. A vocal minority have proposed that C corporations with E&P which convert to S status should be able to purge themselves of E&P by electing to have their E&P taxed to their shareholders as capital gains over a period of years. Whatever the theoretical merits of such a proposal, it is beyond doubt that such an approach would afford attractive bailout opportunities and would require elaborate protective provisions. The necessary result would be a vastly more complicated, rather than a simplified, subchapter S. The proponents of the elective toll charge argue that thereby even S corporations with E&P would be enabled to qualify at reasonable cost for the benefits accorded S corporations without E&P. The Bill as it now stands discriminates against S corporations with E&P in only one regard -- it subjects them to the passive income test. It follows that total elimination of the passive income test should have the ancillary benefit of obviating any necessity to further consider the elective toll charge proposal.

B. The Definition of Qualified Subchapter S Trusts.

Under present law (§1371(g)(3)*) a trust does not fall within the definition of a qualified subchapter S trust (a "qualified S trust") unless all of its income is distributed currently. Bill §1361(d)(3) includes within the definition trusts whose income is required to be distributed currently as well as those whose income actually is distributed currently. However, the Bill follows present law in excluding accumulation trusts from the definition of qualified S trusts.

A basic purpose of the Bill is to remove unnecessary eligibility restrictions and broaden access to S status. In part, the Bill achieves this by increasing the number of permitted shareholders from 25 to 35. Expanding the definition of qualified S trusts to include accumulation trusts obviously would further this objective of the Bill.

Under both present law and the Bill, grantor and similar trusts are permitted shareholders of S corporations and qualified S trusts are treated as if they were grantor trusts. Quite clearly, accumulation trusts can be grantor trusts. Accordingly there is no policy against permitting accumulation trusts as shareholders of an S corporation. Instead the focus, quite properly, is on the requirement that at all times there be a single individual to whom all of the income of the trust derived from or attributable to the stock of an S corporation is taxed, regardless of whether or not that income is distributed currently or accumulated. This requirement already applies to qualified S trusts in the same manner as it applies to grantor trusts.

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* Unless specifically indicated to the contrary, all references herein are to sections of the Internal Revenue Code of 1954, as amended.

In the circumstances, the income distribution requirement in the definition of qualified S trusts serves no purpose. Instead, that requirement operates simply to unnecessarily restrict access to subchapter S and, thus, to defeat a basic purpose of the Bill. The income distribution requirement should be deleted. The word "and" should be added at the end of subparagraph (A) of Bill §1361(d)(3), subparagraph (B) should be deleted, subparagraph (C) should be redesignated (B) and clause (i) thereof should be revised to read as follows:

> "(i) at any time, there shall be only 1 income beneficiary of the trust, who shall be a citizen or resident of the United States,".

Statement to be Submitted to the Committee on Finance at its Hearing September 10, 1982 on the Subchapter S Revision Act of 1982 (S.2350)

Statement of Burton N. Forester on Behalf of the Motion Picture and Television Tax Institute

We appreciate the opportunity to present these comments for consideration by the Committee on Finance of the United States Senate as it debates the Subchapter S revision bill pending before it. We fully endorse the underlying premise of this legislation that tax considerations should be removed from the choice of form for a small business, so taxpayers may choose to conduct their business in corporate or noncorporate form based solely upon business reasons. Unfortunately, the legislation in its present form may continue to deny incorporated independent motion picture and television film producers who actively engage in production from availing themselves of Subchapter S status.

Brief Statement of Problem

The income received from exploitation of motion picture films or television tapes in whose production the independent motion picture company actively participated does not constitute either personal holding company income (Section 543(a)(5)), or foreign personal holding company income of a controlled foreign corporation (Section 954(c)(3)(A); Treas. Regs. Section 1.954-2(d)(1)(ii)(c), Ex. (7)). Yet these same companies are being denied the opportunity to elect Subchapter S status, because of the characterization of their income as passive investment income in the nature of rents or royalties (Section 1372(e)(5)). The proposed repeal of the passive investment income test in the legislation under consideration would principally apply to newly formed companies and not to existing companies with accumulated earnings and profits.

Proposed Solution

Subparagraph (C) of Section 1372(e)(5)[1] relating to the definition of "passive investment income" of small business corporations should be amended to provide that the term does not include "produced film rents" as defined in Section 543(a)(5)(B).

The following suggested legislative language would accomplish this:

> Subparagraph (C) of Section 1372(e)(5) of the Internal Revenue Code of 1954 (relating to passive investment income of small business corporations) is amended by adding at the end thereof the following new sentence: "For purposes of this paragraph, the term "passive investment income" shall not include produced film rents (as defined in Section 543(a)(5)(B))."

Such an amendment is consistent with the action taken in the Select Revenue Measures Subcommittee of the Committee on Ways and Means where interest received on deferred payment sales of inventory and income received from the conduct of a lending or finance business as defined in Section 542(c)(6) are excluded from the term "passive investment income".

While we believe the proposed amendment should be viewed as a clarification of existing law, at a minimum the legislative history should indicate that no reference is to be drawn from its enactment as to the characterization of income received from the exploitation of motion picture films and television tapes in whose production the company actively participated for purposes of the passive investment income test under prior law.

In addition, we believe any independent production company whose election was terminated by reason of the characterization of its income as passive investment income should be permitted to re-elect Subchapter S status without either having to wait five taxable years or obtaining the consent of the Secretary as provided in Section 1372(f).

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[1] Should S.2350 be enacted, Section 1372(e)(5) would become Section 1362(d)(3).

Background and Discussion

In 1958, Congress enacted the Subchapter S provisions (Section 1371-1377 of the Code) in order to permit small business corporations and their shareholders to be taxed in almost all respects like partnerships and partners. Thus, corporations electing this status are not subject to tax but instead, for the most part, "pass through" to their shareholders the taxable consequences of their activities. This election was granted in order to minimize the effect of federal income taxes on businessmen's choices of the form of organization in which they conduct their business.

When these provisions were first enacted, Congress made them applicable only to operating businesses and not to businesses which received significant amounts of passive investment income, such as royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stock or securities.[2] Consequently, under the statute (Sec. 1372(e)(5) of the Code) a corporation is ineligible for Subchapter S treatment if it derives more than 20 percent of its gross receipts from these sources.

In the 1966 amendments to the Subchapter S provisions, the term "passive investment income" was substituted for the term "personal holding company income" as the general category of ineligible receipts under Subchapter S. In making this change, Congress acknowledged its intention "to limit the availability of (subchapter S treatment) to small businesses actively engaged in trades or businesses." S. Rep. No. 1007, 89th Cong. 2d Sess. p. ____ (1966-1 Cum. Bull. p. 532) (emphasis added).

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[2] A proposal to eliminate the passive investment income limitation entirely was included in the legislative proposals presented by the Treasury Department (both the 1968 and the 1969 recommendations) but such proposals were never enacted.

The passive investment income limitation has presented especially difficult problems of interpretation for the gross receipts derived by corporations which produce motion picture films and video tapes even though such corporations have actively engaged in such production. This has occurred principally because the income derived from the exploitation of a motion picture film or video tape is for the right to use property. Traditionally, such income has been characterized as "rents" or "royalties" as for example under the personal holding company provisions (Section 541-545 of the Code).[3] The Regulations under the Subchapter S provisions have defined "royalties" to include copyright royalties (Treas. Regs. Section 1.1372-4(b)(5)(v)) and "rents" as amounts received for the use of, or right to use, property (Treas. Regs. Section 1.1372-4(b)(5)(vi)). However, the Regulations go on to provide that the term "rents" does not include payments for the use of property where significant services are rendered to the lessee in connection with the lessee's use of the property (Treas. Regs. Section 1.1372-4(b)(5)(vi)). The Internal Revenue Service has recently taken the position that receipts from the exploitation of a corporation's motion pictures or television programs constitute "copyright royalties" and not "rents" within the meaning of the above Regulations, thereby effectively excluding these companies from the Subchapter S provisions. Even assuming the receipts were characterized as rental income the services provided by these companies relate to production of the property to be used by the lessee in contrast to the lessee's use of the property once it has been produced, as discussed below, and, consequently, Subchapter S treatment would be similarly denied under this interpretation. Whether this interpretation of the statute is correct has not been reviewed in the courts, but is a source of controversy with the Internal Revenue Service.

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[3] See also Rev. Rul 54-284, 1954-2 Cum. Bull. 275, which holds that for purposes of the personal holding company sections, income received from the distribution of a corporation's motion picture constitutes rental income.

The exploitation of a motion picture film or television tape takes various forms and oftentimes requires large worldwide distribution organizations not generally possessed by small business corporations, the effect of which is to require the corporation to engage others to exploit the film on its behalf. Congress has previously determined that participation in the production of a film in itself "indicates an active business enterprise" (H.Rep. No. 749, 88th Cong. 2d Sess. p. 203 (1964-1 Cum. Bull. Part 2, p. 203) and S.Rep, No. 830, 88th Cong. 2d Sess. p. ____ (1964-1 Cum. Bull. Part 1, p. 613))[4] and that "rental income arising from property manufactured by the taxpayers should be treated as ordinary business income rather than passive...income. It (took) this position because it (believed) that rental income arising from property manufactured by the taxpayer, in reality, is no more passive than sales income derived from property manufactured by the taxpayer." S.Rep. No. 1707, 89th Cong. 2d Sess. p. 63 (1966-2 Cum. Bull. 1103).

We believe these determinations should apply with equal force to the definition of passive investment income under Section 1372(e)(5) with respect to films produced by the small business corporation, since it was the intent of Congress to permit small businesses actively engaged in a trade or business to qualify for treatment under the Subchapter S provisions.

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[4] To the same effect, see S.Rep. 94-938, 94th Cong. 2d Sess. p. 79 (1976-3 Cum. Bull. Vol. 3, p. 117).

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Statement
on
S. 2350
The Subchapter S Revision Act of 1982

The National Cattlemen's Association (NCA) commends Senator Dole and Senator Long for introducing S. 2350, which would make extensive revisions in the income tax treatment of subchapter S corporations and their shareholders. NCA also commends the Congressional staffs and the Treasury Department for their attempts to address all of the significant problems in this area of the tax law.

NCA generally supports the provisions of S. 2350, which would treat the shareholders of a subchapter S corporation more like the partners of a partnership than does present law. In particular, NCA supports the provisions which would:

(1) pass through items of income, gain, loss, deduction, and credit from a subchapter S corporation to its shareholders in a manner similar to the manner such items pass through a partnership to its partners;

(2) allow a shareholder to carry forward his share of the corporation's loss to the extent that the amount of

loss passed through to him for the year exceeds the aggregate amount of the bases in his subchapter S stock and loans to the corporation;

(3) eliminate the passive investment income test for corporations which do not have accumulated earnings and profits; and

(4) revise the rules relating to distributions from subchapter S corporations.

Passive income restrictions

Under present law, a corporation's subchapter S election would be revoked effective as of the first day of any taxable year in which passive investment income is more than 20 percent of its gross receipts. (The sole exception to this rule provides that more than 20 percent of a subchapter S corporation's gross receipts may be passive investment income in the first taxable year in which the corporation commences an active trade or business, and in the succeeding taxable year, so long as the passive investment income in each such year in which the "20 percent test" is not satisfied does not exceed $3,000.)

The bill would eliminate the passive investment income test but only for corporations which do not have any accumulated earnings and profits from years prior to electing the new subchapter S provisions. NCA recommends that the bill should also eliminate the passive investment income test for any corporation with accumulated earnings and profits if all of the accumulated earnings and profits are attributable to years for which the corporation was a subchapter S corporation.

The apparent purpose of retaining the passive income limit for corporations with accumulated earnings and profits is "the concern that the complete repeal of the passive income limit would permit the use of the subchapter S election to avoid shareholder tax on previously accumulated corporate earnings, where the corporation has ceased to conduct an active business." (Joint Committee on Taxation, Description of H.R. 6055: Subchapter S Revision Act of 1982, 28 (June 8, 1982), citing Kadens, "Proposed Subchapter S Amendments -- A Boon to Private Investment Corporations?" 58 Taxes 79 (June 1980).)

The primary situation in which this type of avoidance could occur would involve a corporation which had been a regular (non subchapter S) corporation for a number of years and had not distributed its earnings. On the other hand, a subchapter S corporation's income is taxed currently to its shareholders, whether distributed or not. Notwithstanding this situation, however, a corporation may have accumulated earnings and profits from subchapter S years which have not been taxed to the shareholder because of accelerated depreciation, tax exempt interest, and certain other items which are computed differently for purposes of earnings and profits than for purposes of determining taxable income. These amounts are likely to be relatively minor in comparison with the amount of accumulated earnings and profits of a corporation which has been a regular corporation for at least some period.

There appears to be little or no reason to maintain the passive investment income test for corporations which have been subchapter S corporations at all times prior to the effective date of the new law. The primary effect of the approach taken by the bill would be to provide that any subchapter S corporation which has used accelerated depreciation in prior years would be subject to the passive investment income test notwithstanding the fact that income in later years would be greater because of the reduced depreciation in later years of an asset's useful life (or cost recovery period).

Treatement of pension and profit-sharing plans

Prior to enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (the "1982 Tax Act"), a pension or profit-sharing plan of a subchapter S corporation was subject to special rules in addition to the tax qualification requirements applicable to plans of other corporations. In general, these requirements were somewhat more strict than those for plans of other corporations, but somewhat less restrictive than some of the special qualification rules that apply to a plan benefiting a self-employed individual, such as a sole proprietor or a partner. The 1982 Tax Act contains provisions which are designed generally to achieve parity between plans of self-employed individuals and corporate plans. S. 2350 includes provisions which generally would treat a pension or profit-sharing plan of a subchapter S corporation in the same manner as a plan benefiting self-employed individuals. In view of the 1982 changes, the rules in S. 2350 would appear to be unneccesary.

Treatment of fringe benefits

Under present law, the statutory exemptions for fringe benefits applicable to shareholder-employees of regular corporations also apply in the case of shareholder-employees of subchapter S corporations. The benefits include -- (1) the $5,000 death benefit exclusion; (2) the exclusion from income of amounts paid for an accident and health plan; (3) the exclusion from income of amounts paid by an employer to an accident and health plan; (4) the exclusion of the cost of up to $50,000 of group-term life insurance on an employee's life; and (5) the exclusion from income of meals or lodging furnished for the convenience of the employer.

Under the Subchapter S Revision bill, fringe benefits of any person owning more than two percent of the stock of a subchapter S corporation are treated in the same manner as fringe benefits of a partner in a partnership.

While NCA supports the concept that the rules relating to fringe benefits should not depend upon the form in which the business is conducted, the solution provided by the bill is incomplete and inequitable. Treating subchapter S corporations, their shareholders and employees in the same manner as partnerships, their partners and employees may create a parity between partnerships and subchapter S corporations, but it leaves intact the disparity between partnerships and regular coporations and creates a disparity between subchapter S corprations and regular corporations. However, NCA recognizes that it may be desirable for this bill to restrict or prohibit statutory fringe benefits in the case of subchapter S corporations that are only conducting investment activities and not carrying on a trade or business (especially since regular corporations engaged only in investment activities could not be availed of to provide these benefits without being exposed to the personal holding company tax). For example, it might be desirable to utilize a modified form of the passive investment income test to determine whether a subchapter S corporation could offer statutory fringe benefits. NCA suggests that, at least in the case of corporations conducting active trades or businesses, fringe benefits rules should not be restricted on a piecemeal basis in this bill. Rather, fringe benefits should be examined on a comprehensive basis with a view to applying uniform rules to all taxpayers regardless of the form in which they carry on their business.

SUMMARY OF

PROPOSAL TO AMEND S. 2350 (THE SUBCHAPTER S REVISION ACT OF 1982) TO PROVIDE FOR GRANDFATHER RIGHTS FOR SUBCHAPTER S INSURANCE COMPANIES ADMITTED TO U.S. INSURANCE EXCHANGES PRIOR TO DECEMBER 31, 1984.

Present law:

Insurance companies are permitted to elect Subchapter S status. (Rev. Rul. 74-437)

Proposed Bill:

S. 2350 (H.R. 6055), the Subchapter S Revision Act of 1982, specifically excludes insurance companies from eligibility to elect Subchapter S status.

Proposed Amendment by House Subcommittee on Select Revenue Matters:

To provide limited grandfather rights to

(a) Subchapter S insurance companies in existance, and

(b) Subchapter S insurance companies in the process of formation prior to April 1, 1982, and

(c) companies approved for membership on established insurance exchanges prior to December 31, 1982.

PROPOSAL:

That the Senate Finance Committee adopt the limited grandfather rights adopted by the House Subcommittee on Select Revenue Measures with one change--to permit Subchapter S election for companies approved for membership on established insurance exchanges prior to December 31, 1984.

ARGUMENTS IN FAVOR OF PROPOSAL

1. The bill unexpectedly proposed a reversal of settled prior law on which a number of people have relied, including small companies currently on the Exchanges. The limited grandfather rights as proposed in the House do not fully protect those who have relied in good faith on such settled law, and the two year grandfather rights we propose are necessary fully to protect them.

2. The proposal will eliminate the disparate and inequitable tax treatment between individual American investors in Lloyds of London and individual American investors in companies who are members of the American Exchanges which will occur in Bill is passed as originally proposed or with current House amendment. If this proposal is not adopted, small companies operating on the American insurance exchanges will in 1983 and 1984 be at a severe competitive disadvantage in attracting individual investor capital, vis-a-vis Lloyd's, their larger and better financed competitor, because under a Closing Agreement entered into between the Underwriters at Lloyd's and the Commissioner of Internal Revenue, a U.S. individual investor in Lloyd's receives a pass through of tax accounting treatment. Since the Lloyd's closing agreement expires on December 31, 1984, grandfather treatment to December 31, 1984, for companies operating on the American exchanges is appropriate.
3. Individual investment in insurance exchanges should be encouraged because
   (a) exchanges will bring high paying jobs to core areas of major cities;
   (b) exchanges will reduce the substantial volume of premium dollars now going overseas;
   (c) the exchanges will provide a source for the future capital needs of the insurance industry.
4. To avoid penalizing small businesses who are or will provide service to these companies.
5. Congress needs more time to study this complicated area of the law.

STATEMENT OF ORMOND REINSURANCE GROUP*

This statement is submitted in support of the proposal to amend S. 2350, the Subchapter S Revision Act of 1982 (the "Bill"), to allow corporations approved for membership on an established insurance exchange before December 31, 1984, to elect Subchapter S status.

The Bill, as introduced, states that insurance companies are not eligible to elect Subchapter S status. In the House, the Bill was amended by providing limited grandfather rights to (a) Subchapter S insurance companies in existence, (b) Subchapter S Insurance companies in formation prior to April 1, 1982, and (c) syndicates that are approved for membership on established insurance exchanges prior to December 31, 1982. We would propose that the Senate Finance Committee adopt the limited grandfather rights adopted by the House Subcommittee on Select Revenue Measures, with one exception. That is, to permit Subchapter S elections for syndicates approved for membership on established insurance exchanges prior to December 31, 1984.

*Ormond Reinsurance Group is a small closely held group of companies located in Ormond Beach, Florida, that function primarily as reinsurance underwriting managers. W.J. Burt Management, Inc., an Underwriting Manager on the New York Insurance Exchange,Inc., and The Burt Syndicate, Inc., an Underwriting Member of the New York Insurance Exchange, Inc., are member companies of this Group.

We believe this proposal is just and equitable for the following reasons:

1. As a practical matter, there is not sufficient time before December 31, 1982, to form, capitalize, and have accepted for membership on any of the insurance exchanges any significant number of Subchapter S syndicates. Thus, potential investors in the exchanges will be turned away at a time when the formation and operation of the Exchanges should be encouraged.

   a. The exchanges are located in major cities and will bring high paying jobs to these cities and to other communities throughout the United States. For example, as a result of the involvement of the Ormond Reinsurance Group in the New York Insurance Exchange, we have increased our staff from 100 to 150 (an increase of approximately 18 in New York and 32 in Ormond Beach, Florida). We believe that substantially greater growth could be expected as more syndicates are admitted to these exchanges.

   b. There is a substantial volume to reinsurance premium going overseas, thus adversely affecting the balance of payments and job creation in the United States. (i.e., to Lloyd's of London, the principal competitor of the American insurance exchanges). (In 1980, the

Commerce Department estimated this amount to be $2.1 billion.) The American insurance exchanges were designed to encourage that premium volume to remain in the United States and to encourage foreign premiums to come to the United States. The growth of these American exchanges should be encouraged to attract premium dollars.

c. The current projections indicate that property and casualty insurance premiums in the United States will be $164.8 billion by 1986. In order to support that amount of premium, using the current ratio of premiums to surplus of 1.5 and 1, there must be a surplus of $109.8 billion in the industry. There is currently a surplus of $67 billion. The required additional capital could come from existing companies out of their earnings and profits, but this means that they must raise their rates (thus directly affecting the consumer). It could also come from overseas (either directly throught the establishment of U.S. subsidiaries by foreign companies or indirectly through reinsurance to Lloyd's of London or other overseas companies). Finally, it could also come from individual investors. They could invest in existing companies through stock purchase or they could invest in new companies or syndicates. The historic rates of return in the insurance industry is no greater than other types of investment, so the former option is unlikely to occur to any significant extent. The Bill, in our view, significantly discourages the latter option, for no significant reason.

2. The Closing Agreement between the Underwriters' at Lloyd's and the IRS approves favorable tax status to American investors in Lloyd's syndicates. This agreement can be terminated December 31, 1984. If the Bill, with the limited grandfather rights as are proposed in the House, is adopted, there will be a significant disparity between individual American investors in Lloyd's Syndicates and individual American investors in syndicates on American exchanges. The result is that an individual investor, having decided to invest in the insurance industry, will be more likely to invest in Lloyd's than in the American exchanges, thus sending U.S. dollars overseas and strengthening the position of the major competitor of the American Exchanges.

Small companies operating on the Exchange like the Ormond Reinsurance Group are the most likely to be attracting individual investor capital for the syndicates they manage. Now is a particularly opportune time to attract such capital because of the two and a half year track record of the New York Insurance Exchange and because of the upturn we expect in the insurance business prior to 1985. If the proposed Bill is passed in its present form we will not be able to compete with Lloyd's in attracting such investor capital because of the more favorable tax treatment afforded identically situated investors in Lloyd's. Thus we and other U.S. companies like us will be faced with a situation in 1983 and 1984 in which, in effect, discriminatory U.S. tax laws cause individuals to invest capital in our more established and better financed foreign competitor. We believe such a situation is grossly unfair not only to ourselves but also to the U.S. taxpayer in general. It is inconceivable to us that Congress would enact a law which favors the major competitor of a viable U.S. industry. It is as if Congress were to say that a U.S. investor in Toyota were to be taxed in a special more favorable way than an investor in American Motors.

3. This aspect of the Bill is not simply a modification or liberalization of current law. It is a specific reversal of established prior law upon which individuals and companies, such as ourselves, and the exchanges have previously relied. The practical effect is to discourage individual investment in the insurance industry and to significantly penalize small businesses such as ourselves who would provide services (in our case

underwriting management) to these new syndicates. This is all the more onerous because investment in Lloyd's is encouraged.

4. We firmly believe that the current Bill will significantly affect small business in the United States, and that the revenue lost from these small businesses will be significantly greater than any revenue which may be lost by adopting the amendment proposed in this memorandum.

We would also like to respond to the perceived view that a Subchapter S insurance company is a tax advantage investment or tax shelter or is a vehicle for tax abuse:

5. Under current law, Subchapter S status is allowed for insurance comapnies. We do not believe that there are a significant number of such companies in existence today, thus indicating that this investment vehicle does not provide significant tax benefits to investors. There is no evidence of tax abuse that we are aware of.

6. Subchapter S insurance companies or syndicates do not offer significant tax advantages to investors relative to other types of investments. First, the investor must provide a significant amount of capital in cash, up front. The investment cannot be made piecemeal over several years. Second, there is relatively little, if any, current cash flow to the investor. Whatever is distributed is taxed to the investor. Finally, our preliminary projections indicate that at best, an investor can write off his investment in five to seven years, depending upon the results of the business. These are not unusual figures for any start-up operation.

We would therefore urge the Senate Finance Commitee to carefully consider extending the limited grandfather rights proposed by the House Sucommittee on Select Revenue Measures to allow companies admitted to established insurance exchanges prior to December 31, 1984 to elect Subchapter S status.

STATEMENT OF JAMES S. KAPLAN, ATTORNEY AT STROOCK & STROOCK & LAVAN, WITH REGARD TO SUBCHAPTER S REVISION ACT OF 1982 AND ITS EFFECT ON CASUALTY INSURANCE COMPANIES

My name is James S. Kaplan. I am an attorney associated with the firm of Stroock & Stroock & Lavan which has offices in New York, Miami and Washington, D.C. I am submitting this statement on behalf of the Ormond Reinsurance Group, which with its affiliates is the largest Underwriting Manager and the largest single investor in the New York Insurance Exchange. I am also submitting this statement as an attorney who over the past three years has been directly and personally involved in the formation of the Insurance Exchanges both in New York and in Florida.

In essence, I am here to urge you carefully to consider the potentially devastating impact of the proposed Subchapter S Revision Act on individual investment in the American insurance exchanges. Although this may sound like a highly esoteric issue, I assure you it is one of considerable economic importance to small companies currently operating on the New York Insurance Exchange and on the soon to open Insurance Exchange of the Americas in Miami, Florida, (the "Florida Exchange").

My firm has submitted to the Committee an 18-page memorandum with Exhibits outlining our position in support of a proposal to extend the grandfather rights in the House Bill as reported to the Ways and Means Committee to permit all casualty insurance companies approved for membership on an established insurance exchange prior to December 31, 1984 to operate as under current law. I will only, in the most abbreviated form, recapitulate certain of the most salient points of that memorandum here.

1. Although the proposed Bill has been presented as a "non-controversial" reform bill, it significantly changes prior law with respect to the eligibility of a casualty insurance company to elect Subchapter S treatment. This unexpected denial of the current right to elect Subchapter S treatment in the proposed Bill comes just at a time in which Subchapter S was coming to be recognized as a potentially viable vehicle for individual investment in the emerging U.S. insurance exchanges.

These exchanges, which constitute major economic development initiatives of the states of New York, Florida and Illinois, provide central market places through which small insurance companies -- called syndicates -- accept various risks. The largest such marketplace in the world today is Lloyd's of London, which consists solely of individual investors. The purpose of the formation of the New York and Florida Exchanges was to capture for those states some portion of the $5 billion in annual premium income which currently goes to Lloyd's.

Individual investor capital is critical to the growth of these Exchanges, and particularly to the smaller companies like the Ormond Reinsurance Group which operate management companies on them. This unexpected change in the law relating to Subchapter S insurance companies caught many of these companies off guard, as a number of them had planned to make significant efforts to raise individual capital. The next year-and-a-half was believed to be a particularly auspicious time for such efforts for two reasons. First, it is now for the first time possible to show individual investors the highly successful two-and-a-half year track record of companies operating on the New York Exchange; and second, it is anticipated that beginning in 1983 there will be an upturn in the insurance markets. The proposed bill could pull the rug out from under these efforts. We request that a limited two-year grandfather clause be inserted in the Bill which would permit companies currently planning to seek individual capital to go forward with Subchaper S syndicates. In this two year period Congress and the Treasury will have an opportunity to evaluate the operation of Subchapter S insurance companies to see if there are any abuses.

An even more compelling reason why Subchapter S treatment is appropriate for insurance companies approved for membership in insurance exchanges prior to December 31, 1984 is that analogous tax treatment permitting a pass through of tax accounting methods is available to individual investors in the U.S. exchanges' major competitor -- Lloyd's of London. Under a Closing Agreement entered into by the Internal Revenue Service and the Underwriters of Lloyd's an individual U.S. investor in Lloyd's is permitted to pass through to his own tax return, the Lloyd's special tax accounting method, a form of special insurance company tax accounting. This Closing Agreement expires on December 31, 1984. Thus, if the proposed Bill is passed with the provision ending Subchapter S insurance companies as of December 31, 1982, companies like the Ormond Reinsurance Group, which operate underwriting management companies on the U.S. exchanges will be at a severe competitive disadvantage in attracting individual investor capital vis-a-vis their major competitor -- Lloyd's of London. In addition to having three hundred years of history and reputation to offer to such investors, Lloyd's will also be able to offer them a pass through of tax accounting methods, which an investor in the U.S. exchanges will be denied because of discriminatory U.S. tax policies. It is submitted that there is no reason in either logic or public policy to place American exchanges and companies in the Underwriting Management business on such exchanges at such an unfair disadvantage vis-a-vis their more established and better financed foreign competitors. It would be as if an investor in General Motors (or perhaps more analogously, Toyota) were taxed one way during 1983 and 1984, and an investor in American Motors or Delorean Motors would be taxed in these years in another less favorable way. Such a situation is directly contrary to the basic principle that similarly situated individuals must be taxed similarly, which stems from the basic tenet of equal protection of the law.

Extending the proposed grandfather rules as we propose to 1984 would preserve a rough equality of tax treatment between investors in Lloyd's and investors in U.S. exchanges until the Lloyd's Closing Agreement expires. At that time, Congress and the Treasury could evaluate the situation in a more deliberate manner.

I therefore urge that the grandfather rules be extended to permit insurance companies approved for membership on U.S. exchanges to be eligible, as under current law, for Subchapter S treatment prior to December 31, 1984.

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MEMORANDUM IN SUPPORT OF PROPOSAL TO EXTEND GRANDFATHER RULES FOR SUBCHAPTER S INSURANCE COMPANIES ADMITTED TO U.S. INSURANCE EXCHANGES TO DECEMBER 31, 1984.

The purpose of this memorandum is to explain why the Senate Finance Committee should permit companies admitted to U.S. insurance exchanges prior to December 31, 1984 to elect Subchapter S treatment.

I. Summary

The Subchapter S Revision Act of 1982 (the "Bill") as submitted to the Senate Finance Committee proposes a complete reversal of prior law in that it would no longer permit casualty insurance companies to be eligible for Subchapter S treatment. There was absolutely no advance warning prior to the time the Bill was first made pubicly available on April 1, 1982 that such a drastic change was contemplated. On June 23, 1982 the Subcommittee on Select Revenue Measures of the House Ways and Means Committee voted to eliminate the restriction in the House version of this Bill on Subchapter S companies electing insurance company tax accounting. Three weeks later this decision was reversed so that in general grandfather rights are permitted only for companies admitted to an insurance exchange prior to December 31, 1982.

This grandfather provision should be expanded to permit Subchapter S elections for insurance companies admitted to an insurance exchange prior to December 31, 1984 for the following reasons:

1. The proposed Bill, which first became available in draft form on April 1, significantly and unexpectedly disturbs settled tax principles applicable to Subchapter S insurance companies on which a number of interested parties have relied. The prior law permitting casualty insurance companies to elect Subchapter S was specifically relied upon by the Florida legislature in setting the capital requirements for the Insurance Exchange of the Americas (the "Florida Exchange"), and by a number of others around the country who are in various stages of attempting to raise capital for such investments in the Exchanges. Additional protection is necessary for those who have acted in reliance on prior laws and for the exchanges

themselves. It is therefore proposed that existing law with regard to Subchapter S insurance companies be retained until December 31, 1984.

2. The proposed Bill will result in U.S. tax policy which unfairly discriminates against individual investors in U.S. insurance exchanges while permitting pass through tax status to individual investors in their principal competitor - Lloyd's of London. There is no justification in either logic or public policy for this distinction in the tax treatment of investors in Lloyd's and these exchanges. Since the Closing Agreement between the Internal Revenue Service and the Underwriters at Lloyds permitting such treatment expires on December 31, 1984, it is appropriate that the pass through of insurance company tax accounting permitted under current law be retained until December 31, 1984 as well, in order to retain a parity of tax treatment between similarly situated investors.

3. The proposed Bill makes radical changes in existing law at a time at which the applicable legal principles relating to the pass through of insurance company accounting methods with respects to partnerships and individual is unsettled. Although the Bill has been the result of an extensive study process, the changes affecting Subchapter S insurance companies have not. The provision eliminating the

long-standing policy of eligibility of casualty insurance companies for Subchapter S elections unexpectedly appeared in the April 1 draft of the Bill without prior notice to or discussion by practitioners in this highly specialized area of law. The limited two-year grandfather rights requested would freeze the status quo as respects insurance while Congress, the I.R.S. and private practitioners could work out a deliberate and considered solution to these issues.

4. Subchapter S insurance companies do not present potential for tax abuse. Investments in such companies are not "tax shelters" and the tax losses generated by such investments are (1) limited to the actual amount invested, and (2) no greater than would be generated by most other start up businesses. There have not been any abuses in connection with such companies to date, and a fair analysis of the anticipated results such investments indicates that there is unlikely to be such abuse in the future.

5. The proposed elimination of Subchapter S insurance companies could have significant adverse economic impact on individual investors and small companies operating on the recently formed insurance exchanges in New York, Florida and Illinois. The formation of the exchanges represents major economic development initiatives of these states, and the

sudden elimination of Subchapter S could severely constrict the flow of individual investor capital into the exchanges at a critical point in their development.

For these reasons, a limited grandfather clause freezing the status quo for two more years is appropriate to provide time for further study, prior to the end of 1984. The grandfather rights requested would freeze the current situation while a deliberate solution to currently outstanding problems with regard to related issues such as the proper tax accounting method for partnerships in the insurance business could be worked out.

II. Background and History

In Rev. Rul. 74-437, 1974-2 C.B. 374[1], the Internal Revenue Service ruled that a casualty insurance company is eligible to elect Subchapter S status. Thus, since 1974 it has been clear that Subchapter S is available to casualty insurance companies. However, because Subchapter S status at the time was limited to corporations with 10 shareholders or less, and conventional insurance companies generally require an initial capital of several million dollars to begin operations (in New York, for example, by law a minimum of $3.6 million is necessary) few casualty insurance companies have elected Subchapter S status. Nevertheless, some privately held casualty insurance companies have been Subchapter S companies even prior to 1980. Prior to the appearance of the Bill, there was no serious doubt or controversy about the ability of a casualty insurance company to elect Subchapter S status.

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[1] A copy of this ruling is attached as Exhibit A.

On April 1 of this year the initial draft of the Bill proposed an abrupt reversal of this previous policy by making all companies taxed as casualty insurance companies ineligible for Subchapter S treatment. Committee staff and some outside commentators such as the ABA tax section apparently believed that since few if any such companies existed, the proposed change would cause little hardship or controversy. In point of fact, there was apparently a lack of understanding of the importance of Subchapter S to individual investor insurance syndicates on the recently formed insurance exchanges in New York, Florida and Illinois. These exchanges constitute some of the major economic development initiatives in these states. Many people affiliated with these exchanges have relied on the existence of Rev. Rul. 74-437 in planning their activities.

The American Insurance Exchanges

A. New York

In 1978, the New York legislature after years of extensive study and preparation enacted a bill providing for the formation of the New York Insurance Exchange (the "New York Exchange"). The New York Exchange was created to provide for the first time in the United States a central marketplace through which transactions involving reinsurance and special risk direct insurance could be effected in the same way that such transactions are effected on Lloyd's of London, the 300 year-old British institution which today is the central insurance and reinsurance marketplace in the world. In fact it is estimated that half of the $5 billion in annual premium insurance written by the Underwriters of Lloyd's is derived from risks located in the United States. The hope of the projectors of the New York exchange was to capture some portion of this business for the United States.

An investor in the New York Exchange in essence buys stock in a small insurance company (called a syndicate). That syndicate then accepts various risks brought to the exchange floor. Under the rules of the New York Exchange, $3.6 million is the minimum capitalization required to form a syndicate. The syndicate must under current rules be capitalized with cash within six months after acceptance. The New York Exchange is thus in essence a market place through which small insurance companies compete with large entities in the reinsurance business. Although the Underwriting members of the New York

Exchange include most of the giants of the U.S. reinsurance business (i.e. AIG, Continental, General Reinsurance), the most active writer of business on the New York Exchange to date has been the W.J. Burt Management Co., a subsidiary of the Ormond Reinsurance Group, a small closely held Florida company with approximately 150 employees. This company wrote approximately 20% of the business written on the New York Exchange in 1981 and its stockholders are also the largest single investors in the Exchange. It is small companies operating on the exchange like Ormond Reinsurance Group that will be most adversely affected by the sudden elimination of Subchapter S insurance company status. Unlike the larger companies in the Exchange which have vast other interests, these smaller companies have made the Exchange a major focus of their business, and it is they who are most actively seeking the individual investor capital that Subchapter S will help provide.

B. Florida

In 1980, the State of Florida enacted legislation creating the Insurance Exchange of the Americas (the "Florida Exchange"). The Florida Exchange is closely patterned in structure on the New York Exchange, and its constitution and by-laws are substantially similar to those of the New York Exchange, except for one significant difference. The minimum capital necessary to form a syndicate on the Florida Exchange was reduced from the $3.6 million on the New York Exchange to $1.5 million. This action was taken after spirited debate, upon the advice of tax counsel in specific reliance on the published I.R.S. position in Rev. Rul. 74-437 with regard to Subchapter S insurance companies.

Unlike the New York Exchange, whose initial financial support came largely from the nation's leading insurers, the Florida Exchange was always intended to be a small investor exchange. The Florida Exchange has actively promoted itself as a Lloyd's type of small investor exchange and a number of Subchapter S syndicates on that exchange are now in formation. The Florida Exchange expects to open in October.

III. Analysis of Reasons Why Grandfather Treatment is Appropriate

1. There Has Been Significant Reliance on Prior Law

As indicated above, the appearance of the proposed Bill in draft form on April 1, 1982 was the first public notice that this complete reversal in prior law was contemplated. Prior to that time a number of interested parties had spent considerable time evaluating possible participation in the New York Exchange via the use of a Subchapter S corporation. Some of these people had circulated written prospectuses and some had not.

In the case of the Florida Exchange the tax advisors to the Committee drafting the Constitution and By-laws of the Exchange specifically relied on Rev. Rul. 74-437 in recommending that the minimum syndicate capital be reduced from $3.6 million to $1.5 million. This recommendation was followed by the state legislature in the bill creating the Florida Exchange. Thus, in the case of Florida it was not only individual investors who relied on prior law, it was the whole state legislature in formulating one of its major economic development initiatives.

Therefore, there has been significant reliance on existing law. The Bill as introduced takes the draconian stance that all Subchapter S insurance companies would be ineligible for Subchapter S treatment as of the end of this year. The House bill as reported to the Ways and Means Committee takes the view that there is to be a grandfathering of existing companies under current law. While the limited grandfather rights in the Bill as reported to the House Committee may provide some protection to the Florida Exchange, they provide very little protection to those who had spent time and effort attempting to organize syndicates of individual investors on the New York Exchange, and whose efforts had not resulted in a written prospectus circulated prior to April 1. These parties will have great difficulty under the current grandfather rules in raising capital prior to December 31, 1982, and it is unclear whether under the rules of the New York Exchange grandfather protection will be available. Thus, because of a sudden unexpected shift in tax policy, a number of interested investors and others in the New York Exchange will be unable to participate in Subchapter S syndicates despite significant planning. The proposed grandfather rules will permit old law to apply to exchange syndicates prior to December 31, 1984, so that currently planned efforts can go forward.

2. The Bill Will Create Unwarranted Discrimination Between Investors in U.S. Exchanges and Investors in Foreign Exchanges.

One of the most disturbing aspects of the current Bill if passed is the discrimination the Bill creates between individual investors in U.S. insurance exchanges, and individual investors in Lloyd's of London, the American insurance exchange's more established and better financed competitor.

Under a Closing Agreement entered into on April 1, 1980 between the Internal Revenue Service and the Underwriters of Lloyds, United States citizens investing in Lloyd's are taxable directly on all profits and losses attributable to their activities, and are entitled to use a special accounting system known as the "Lloyd's accounting method." Thus with respect to U.S. investors in Lloyd's there is no question that profits and losses of insurance operation pass through to their individual tax returns. With the elimination of Subchapter S insurance companies, profits and losses will not pass through to individual investors in U.S. insurance exchanges. Individual investors in U.S. insurance exchanges will thus be at a severe competitive disadvantage vis-a-vis investors in Lloyd's. There is absolutely no justification in either logic or public policy for such a distinction in the tax treatment of investors carrying out basically the same activity. Such an invidious discrimination in the tax treatment available to similarly situated taxpayers will have a severe adverse impact on the Underwriting Managers and other firms operating on the U.S. exchanges. Ormond Reinsurance, for example, believes that by the middle of 1983, the current downturn in the reinsurance industry will be over, and there will be a contraction of Underwriting capacity. Therefore in 1983 and 1984, it will be critical to its business to be able to attract investor capital. In seeking individual investors for its activities in the New York Exchange, it will be in direct head to head competition with Lloyd's. If the U.S. tax laws provide that an investor in Lloyd's is taxed more favorably than an investor in the U.S. exchanges, Ormond Reinsurance and similarly situated companies will not be able to compete effectively in 1983 and 1984 in attracting the individual investor capital necessary to its operations with similarly situated companies operating on Lloyd's. This is exactly the kind of manifest and unjustifiable discrimination, which the Courts have found to be an abuse of discretion on the part of the I.R.S. in a number of cases. See e.g., International Business Machines Corp. v. United States, 343 F.2d 914 (Ct. Cl. 1965).

The Lloyd's closing agreement expires on December 31, 1984. The grandfather rights as proposed in this memorandum would permit Subchapter S treatment for insurance companies approved for membership on an established exchange until that date. Thus, if this proposal is accepted there would be a parity of tax treatment between investors in both American and foreign exchanges prior to that date, and then the situation could be evaluated by the Treasury and Congress.

3. The Proposed Bill Makes Significant Changes In Existing Law Without Sufficient Deliberation.

As has been indicated above, the proposed Bill makes significant changes in current law which apparently were not anticipated by the Bill's draftsmen. There is no indication that either the ABA tax section or the Congressional staff that drafted the Bill were aware of the existence of Subchapter S insurance companies or the broad reliance on Rev. Rul. 74-437.

Since these changes were first made public on April 1, 1982, the Bill has moved with great speed, and many interested parties whose rights are affected have not had sufficient opportunity to be heard. It is also submitted that neither Congress nor the Treasury Department has had sufficient opportunity to consider the impact of the proposed changes.

This is an area in which there is considerable confusion and uncertainty, as is amply illustrated by the fact that Florida legislature in designing its Insurance Exchange was proceeding on a set of legal precedents, of which the draftsmen of the Bill and the ABA tax section apparently had no knowledge. It is also illustrated by the inability of the I.R.S. to rule for three and a half years on pending applications in the somewhat related area of the proper tax accounting status of partnerships.

This "noncontroversial" reform Bill designed to simplify and liberalize Subchapter S is not the proper vehicle to resolve these issues or to make substantive changes in controversial areas without a full opportunity for discussion and debate. The issues involved in this question could have a long term impact on the structure of one of the fastest growing sectors of the U.S. insurance market - the U.S. insurance exchanges.

The two-year grandfather rights proposed will give Congress and the Treasury the time more carefully to consider the problems raised by Subchapter S Insurance companies, and to act more deliberately in this area.

4. Subchapter S Insurance Companies Do Not Present the Potential for Tax Abuse.

In the debate in the House there appeared to be an unspoken fear by the Treasury Department that Subchapter S insurance companies would be used as a device for tax abuse. These fears are without foundation. Firstly, there is absolutely no evidence that Subchapter S insurance companies have under current law been a vehicle for tax shelter or abuse. There is similarly no evidence that they will become such a vehicle.

Since there is only one Subchapter S syndicate currently operating on an insurance exchange, it is difficult to generalize as to what the tax configurations of such syndicates would be. Preliminary projections by the W.J. Burt Management, Inc. indicate, however, indicate that, assuming a loss ratio equal to the industry average, in none of the first five years of operation would the deductions generated by such an investment exceed 15% of the amount invested. In fact depending on investment policy and profitability, there could be a profit after the initial phase of operations. Furthermore, it must be emphasized that it is never possible for the amount of deductions claimed to exceed the actual investment.

Thus, a Subchapter S insurance syndicate is not a tax shelter. It is merely a vehicle to permit an individual investor in an insurance syndicate to be taxed in the same manner as a corporate investor, and to permit an individual engaging in such a business to obtain the benefits of a pass through of deductions and income available to individuals engaging in other businesses through Subchapter S companies.

The abuses which are apparently feared by the Treasury Department in connection with this type of investment do not exist.

5. The Elimination of Subchapter S Insurance Companies Will Have An Adverse Economic Impact And Will Significantly Hurt Small Businesses Operating on the Insurance Exchanges.

A further point not to be ignored is that the elimination of Subchapter S insurance companies will significantly constrict the flow of individual investor capital into the various insurance exchanges. This could have a significant adverse impact on the exchanges, and particularly on the small companies that operate on them.

These exchanges represent major economic development initiatives by the states that formed them. One recent study submitted to the New York State legislature projected that by 1992 the New York exchange could generate 20,000 additional jobs in New York City.[2]

One of the most interesting phenomenon of the New York Exchange has been that although the giants of the industry are represented on the exchange, it is the small businesses that have been the most active users of the exchanges. As indicated above, the most active writer of business on the New

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[2] See study by the Diebold Group Inc. attached as Exhibit B. Also attached is a study by State Senator Manfred Ohrenstein of the New York State Senate.

York Exchange and the largest individual investor has been companies and individuals affiliated with the Ormond Reinsurance Group, a small closely-held corporation headquartered on Ormond Beach, Florida. This company is extremely interested in the potential of Subchapter S companies as a vehicle for investors in the New York Exchange, and has requested to testify at the Senate hearings. A similar phenomenon appears to be occurring in Florida, as small companies with high hopes are organizing to compete in this new and rapidly expanding market.[3]

The elimination of insurance company eligibility for Subchapter S treatment strikes a particulary hard blow to these smaller companies which use the insurance exchanges as a major focus for their business. Thus, the great irony of this "reform" Bill is that in the insurance industry at least it is most harmful to the very small companies it allegedly seeks to protect.

It is these small companies on the insurance exchanges that are requesting grandfather rights preserving existing law until December 31, 1984.

James S. Kaplan

Dated: September 8, 1982

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[3] An article from the Miami Herald describing this phenomenon is attached as Exhibit C.